S. Hrg. 101-440

ABUSES IN THE SECTION 8 MODERATE REHABILITATION PROGRAM

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE REPORT OF HUD'S INSPECTOR GENERAL WITH RESPECT TO THE MISMANAGEMENT OF THE SECTION 8 MODERATE REHABILITATION PROGRAM AND WHETHER REMEDIAL ACTION SHOULD BE TAKEN OR LEGISLATION PROPOSED IN ORDER TO CURB THE ABUSE; THE BLATANT UNECONOMICAL USE OF FEDERAL DOLLARS WHICH WERE INTENDED FOR HOUSING THE POOR BY FORMER HUD OFFICIALS IN THE MOD REHAB PROGRAM; AND EXPLORING HOW FAIR MARKET RENTS, COINSURANCE, AND THE LOW-INCOME TAX CREDIT WORKED TOGETHER IN COMBINATION WITH THE MOD REHAB PROGRAM TO CREATE THE ABUSES WE HAVE SEEN ALSO TO PROVIDE THE BASIS FOR LEGISLATIVE WORK THAT WILL RESTRUCTURE AND ELIMINATE THE POTENTIAL FOR FRAUD BY PERSONS BOTH INSIDE AND OUTSIDE OF THE GOVERNMENT

MAY 17, AUGUST 2, SEPTEMBER 18, 28, 29, AND OCTOBER 31, 1989

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
22-826 WASHINGTON : 1990

S241-7

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, Jr., Michigan, *Chairman*

ALAN CRANSTON, California
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee
TERRY SANFORD, North Carolina
RICHARD C. SHELBY, Alabama
BOB GRAHAM, Florida
TIMOTHY E. WIRTH, Colorado
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada

JAKE GARN, Utah
JOHN HEINZ, Pennsylvania
ALFONSE M. D'AMATO, New York
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
WILLIAM V. ROTH, Jr., Delaware
NANCY LANDON KASSEBAUM, Kansas
LARRY PRESSLER, South Dakota

Kevin C. Gottlieb, *Staff Director*
Lamar Smith, *Republican Staff Director and Economist*
Steven B. Harris, *General Counsel*
W. Donald Campbell, *Staff Director, Housing Subcommittee*
Raymond Natter, *Republican General Counsel*

CONTENTS

WEDNESDAY, MAY 17, 1989

Page

- Opening statement of Chairman Riegle ... 1
- Opening comments of Senator D'Amato ... 9
  - Prepared statement ... 9
- Opening comments of Senator Bryan ... 10
- Prepared statement of Senator Shelby ... 11
- Opening statements of:
  - Senator Dixon ... 12
  - Senator Cranston ... 12
  - Senator Sasser ... 14
  - Senator Garn ... 34
  - Senator Graham ... 34
  - Senator Pressler ... 35

WITNESSES

- Paul A. Adams, inspector general, Department of Housing and Urban Development, Washington, DC, accompanied by Alvin Tucker, deputy inspector general, John H. Greer, deputy assistant inspector general for audit, and Patrick J. Neri, assistant inspector general for investigations ... 15
  - Former HUD employees had access to inside information ... 16
  - Interview with Secretary Pierce ... 17
  - Prepared statement ... 19
- Panel discussion:
  - Contradictory statements ... 35
  - Fees earned from projects ... 36
  - Investigation to continue ... 42
  - Average consultation fee ... 44
  - Taxpayers being victimized ... 46
  - Tax credits ... 49
  - Coinsurance ... 51
- Edward W. Brooke, attorney, O'Connor and Hannan, Washington, DC ... 54
  - Inappropriate influence accusation ... 55
  - Funds allocated on a discretionary basis ... 61
  - Time sheets ... 64
- Richard Shelby, former consultant, Washington, DC ... 67
  - Employment with the Federal Government ... 67
  - Approaches made to HUD ... 70
  - Project fees ... 71
  - Meetings at HUD ... 72
  - Money out of proportion for amount of work done ... 76
  - UDAG fee from Cleveland ... 77
  - HUD contacted developer in acquiring a project ... 80
  - Return to Washington ... 81
  - News accounts incorrect ... 86
- Judith Siegel, president, Lundex Corp., Warwick, RI, and Fred Bush, former consultant, Washington, DC ... 89
  - Character and integrity questioned ... 90
  - Fees paid by developers and private capital ... 92
  - Prepared statement ... 93
- Discussion:
  - Experience as a developer ... 98

Page

Discussion—Continued

- System is headquarters driven 99
- How was the $300,000 divided? 102
- Financial relationship with clients 104

WEDNESDAY, AUGUST 2, 1989

Opening statements of:

- Senator Graham 113
- Senator Dixon 114
- Senator Mack 120

Opening remarks of Senator D'Amato 138
- Prepared statement 138

WITNESSES

Donald Terner, president, BRIDGE Housing Corp., San Francisco CA 115
- Debt/equity financing 117
- Flexible programs 118
- Other forms of assistance 119
- Discretionary funds 123
- Profit margin 124

Judy Truett, chief, Housing Assistance Division, Jacksonville, FL 126
- Local level selection of projects 126
- Some program failures 127
- Ongoing training in financial areas 129
- Regular monitoring 130
- Social services component 130

Panel discussion:

- Determining the rent structure 140
- Guaranteed profits without risks 142
- Income tax credits 143
- Limited returns 147

John M. Ols, Jr., Director, Housing and Community Development Issues, Resources, Community, and Economic Development Division, U.S. General Accounting Office, Washington, DC 149
- Prepared statement 155
  - Moderate Rehabilitation Program 156
  - Tax credits for low-income housing 156
  - Cash flow analyses for selected projects 157
  - Observations 158
  - Exhibit 1. Estimated cash-flow 159

Witness discussion:

- Waiver of the fair share process 164
- Why Denver? 167

Paul A Adams, inspector general, Department of Housing and Urban Development, Washington, DC 172
- Prepared statement 175
  - Use of consultants 175
  - Fair share allocation problems 176
  - Excessive subsidies at many Mod Rehab projects 176
  - Attachments 1–4 178

Morton Schussheim, senior specialist in housing, Congressional Research Service, Library of Congress, Washington, DC 184
- Prepared statement 186
  - How rental markets were classified 187
  - Developers choice of market areas 188
  - Tables A and B 190

Panel discussion:

- Fair market rents 192
- Coinsurers 253
- Excessive fair market rents 256
- Confusion at HUD 259
- Reaction to excessive profits 261
- National Affordable Housing Act 262

Page

- Panel discussion—Continued
  - Possible adjustments to contracts 267

MONDAY, SEPTEMBER 18, 1989

- Opening statement of Chairman Riegle 269
- Opening statements of:
  - Senator Graham 271
  - Senator Dixon 278
  - Senator Shelby 284

WITNESSES

- Melvin Adams, assistant executive director/director of development of the Housing Opportunities Commission of Montgomery County, Kensington, MD 272
  - Fair share formula 272
  - Prepared statement 274
- Witness discussion:
  - Calculation of fair market rents 278
  - Expediter fees 281
  - Favored projects 283
  - From fair share to a discretionary base 285
  - Fairness and equity in rental calculations 287
  - Influence peddling 290
  - Dade County projects 291
  - Process of directing funds 294
  - Allocation of units between elderly and families 295
  - Exorbitant rents 298
- John C. Weicher, Assistant Secretary for Policy Development and Research, HUD, Washington, DC 301
  - Prepared statement 305
    - Overview 306
    - FMR standard 306
    - Data sources 306
    - Public comments 307
    - FMR modifications and exception rents 307
    - Background statement 309
- James Logue, Deputy Assistant Secretary for Multifamily Housing Programs HUD, Washington, DC 316
  - Definition of rent comparability 316
  - Rent calculation process 321
  - Insufficient accountability 322
  - Corrective steps at HUD 322
  - Prepared statement 323
- Panel discussion:
  - Fair market rents 335
  - Return to fair share allocation 338
  - Exception rents 343
  - Determining Federal Government's share of subsidy 345
  - Rents in areas of economic decline 347
  - Establishing rental rates and the coinsurer 348
  - Waivers for rehabilitation costs 348
  - Behind-the-wall costs 349
  - Oversight by OMB 353
  - Adequate staff 356

THURSDAY, SEPTEMBER 28, 1989

- Opening statement of Chairman Riegle 359
- Opening statements of:
  - Senator Garn 360
  - Senator Cranston 422

WITNESSES

Page

Paul A. Adams, inspector general, Department of Housing and Urban Development, accompanied by Chris Greer, assistant inspector general for audit, Department of Housing and Urban Development, Washington, DC 362

  Loan underwriting 362

  Benton Mortgage Co 363

  Prepared statement 364

Witness discussion:

  Coinsurance program 380

  December 1988 audit report 382

  Capital requirements 384

  Direct endorsement 387

  Waivers 389

  HUD oversight 390

Peter Monroe, consultant, Department of Housing and Urban Development, Washington, DC; and Walter Sevier, deputy regional administrator, Texas Department of Housing and Urban Development, Fort Worth, TX, accompanied by James Logue, Deputy Assistant Secretary for Multifamily Housing, Department of Housing and Urban Development 394

  Prepared statement 399

    What coinsurance provides 400

    History of coinsurance 401

    How coinsurance works 402

    What coinsurance offers borrowers 404

    How coinsurance works with GNMA's mortage-backed securities program 406

    How coinsurance was used in conjunction with the section 8 Moderate Rehabilitation Program (MRP) 408

    What went wrong with coinsurance 411

    Corrective actions taken to date 414

    Conclusion 418

Witness discussion:

  Review by outside accounting firm 419

  Some of the issues 420

  Timetable for reform 421

  Review mechanisms of Federal subsidies 424

  Evaluation of current projects 426

  Mod Rehab/coinsurance programs 428

  Two problems in the coinsurance program 432

  Federal multifamily insurance program 433

  Default of Colonial House project 436

Gaye G. Beasley, president, Patrician Mortgage Co., representing the Mortgage Bankers Association of America 437

  Prepared statement 440

    Insurance and Coinsurance success 442

    Filling the market gap 444

    Current problems 446

    Proposed solutions 447

    Recommendations 448

    Exhibit 1-4 452

    Attachments A and B 467

Witness discussion:

  Difference in financing costs 471

  Eligibility of the loan 472

FRIDAY, SEPTEMBER 29, 1989

Opening statement of Chairman Riegle 477

Opening statements of:

  Senator Graham 475

  Senator Garn 476

  Senator Dixon 477

  Senator Cranston 501

WITNESSES

Page
John M. Ols, Jr., Director of Housing and Community Development Issues Resources, Community and Economic Development Division, GAO, Washington, DC., accompanied by Dennis Fricke, Assistant Director, Housing and Community Development Issues Resources, Community and Economic Development Division, GAO; Richard Greene, evaluator-in-charge, Housing and Community Development Issues Resources, Community and Economic Development, GAO; and Margaret L. Arman, counsel, Office of the General Counsel, GAO 478
  Prepared statement 483
    Need for centralized review of financial assistance 485
    Impact on low-income families 486
    Observations on tax credit legislation 488
    Attachments I and II 492
Witness discussion:
  Tax Credit Program 494
  Utilization of tax credits 496
  Oversupply of housing units 499
  Reasonable profit margins 502
Trudy McFall, executive director, Maryland Community Development Administration, Annapolis, MD 505
  Prepared statement 510
    State allocation plans and project evaluations 511
    Combining Federal subsidies 514
    The credit allocation process as a model 516
Benson F. Roberts special assistant for policy and program development, Local Initiatives Support Corporation, Washington, DC 518
  Prepared statement 522
    Background of LISC 523
    The emergence of CDC's 524
    Combining housing subsidies 526
Panel discussion:
  Soft market areas 532
  Allocation priority 534
  One process is needed 535
  IRS monitoring 536

TUESDAY, OCTOBER 31, 1989

Opening statement of Chairman Riegle 563
Opening remarks of Chairman Riegle 539
  Prepared statement 541
Opening remarks of Senator Graham 540
  Prepared statement 541
Opening statements of:
  Senator Dixon 542
  Senator Sasser 542
  Senator Garn 542
Opening remarks of Senator D'Amato 561
  Prepared statement 562

WITNESSES

William M. Diefenderfer III, Deputy Director OMB, Washington, DC 543
  Prepared statement 545
    The problems at HUD 545
    OMB management oversight 547
    Management integrity—focus on the highest risk areas 549
    The Presidential MBO process 551
    Financial management improvements 553
    Conclusions 556
Witness discussion:
  Management controls and responsibilities 558
  Adequate procedures and staff 559
  Recommendations for oversight 565
  Tools for monitoring the health of an agency 567

Page
Witness discussion—Continued
    Low-income housing tax credit 568
Richard Davis, former Associate Director for Cabinet Affairs, the White House 570
    Prepared statement 572
Carol Crawford, former Associate for Economics and Governments, OMB, Washington, DC 575
    Prepared statement 577
Panel discussion:
    Involvement of White House staff 579
    Access to records 581
    Deborah Gore Dean 583
    Internal review mechanisms 586
    Federal Home Loan Bank Board 588
    Political favoritism 592
    Failure of oversight 593
    Elimination of waste, fraud, and abuse 595

Additional Material Supplied for the Record

Letter to Senator Graham from Richard L. Bowers, Director, Department of Housing and Urban Development, Jacksonville, FL, dated August 10, 1989 599
Statement of Arthur R. Hessel, Kelley Drye & Warren dated May 26, 1989 603

ABUSES IN THE SECTION 8 MODERATE REHABILITATION PROGRAM

WEDNESDAY, MAY 17, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m., in room SD-538 of the Senate Dirksen Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Shelby, Graham, Bryan, Garn, D'Amato, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

Senator **RIEGLE**. The committee will come to order. I'll give people a minute to find seats.

Senator Garn and other members have indicated that since there are several committees markups this morning and that they will have to go back and forth to establish quorums, so that nominations can be reported out today.

Specifically, Senator Garn wanted me to indicate that he would be here shortly when he completes work in two other committees this morning.

I have a few opening comments that I want to make; then, I will yield to Senator D'Amato.

First of all, let me welcome all of you here this morning. I will make an opening statement shortly; but before doing so, I want to indicate for the record that I have two letters that I want to reference. One is a letter that I sent yesterday to Comptroller General Bowsher asking the GAO to begin a systematic inquiry into the section 8 Moderate Rehab Program and to look at some very specific projects identified by the inspector general's office.

I will not read the text of that letter, but I have it here and it's available for those who may want copies of it. We'll also insert that in the record.

DONALD W. RIEGLE, JR., MICHIGAN, CHAIRMAN
ALAN CRANSTON, CALIFORNIA
PAUL S. SARBANES, MARYLAND
CHRISTOPHER J. DODD, CONNECTICUT
ALAN J. DIXON, ILLINOIS
JIM SASSER, TENNESSEE
TERRY SANFORD, NORTH CAROLINA
RICHARD C. SHELBY, ALABAMA
BOB GRAHAM, FLORIDA
TIMOTHY E. WIRTH, COLORADO
JOHN F. KERRY, MASSACHUSETTS
RICHARD H. BRYAN, NEVADA
JAKE GARN, UTAH
JOHN HEINZ, PENNSYLVANIA
ALFONSE M. D'AMATO, NEW YORK
PHIL GRAMM, TEXAS
CHRISTOPHER S. BOND, MISSOURI
CONNIE MACK, FLORIDA
WILLIAM V. ROTH, JR., DELAWARE
NANCY LANDON KASSEBAUM, KANSAS
LARRY PRESSLER, SOUTH DAKOTA
KEVIN C. GOTTLIEB, STAFF DIRECTOR
LAMAR SMITH, REPUBLICAN STAFF DIRECTOR AND ECONOMIST

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

May 16, 1989

The Honorable Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
Washington, D.C. 20548

Dear Comptroller General Bowsher:

The Senate Committee on Banking, Housing and Urban Affairs, which has jurisdiction over the Section 8 Moderate Rehabilitation program, is deeply concerned by a recent HUD Inspector General report indicating that scarce Federal resources, designed to provide housing for low income families, may have been squandered through mismanagement by the Department of Housing and Urban Development.

The Mod Rehab program was intended to provide only a modest incentive for owners to finance small-scale rehabilitation with private financing. Yet, the IG's investigation indicates that developers were willing to pay consultants hundreds of thousands of dollars to influence the HUD selection process. Since consultant fees are not an eligible project cost under the Mod Rehab program, such costs could only have been economically justified if the projects generated cash flows that were much larger than those intended by Congress.

The IG's report suggests that certain developers were allowed to distort the program so that it would provide guaranteed rent rolls for large projects that could obtain other incentives, such as tax exempt bonds, low-income housing tax credits, and financing under the HUD co-insurance program.

The Committee requests the General Accounting Office (GAO) to examine a representative sample of the projects identified in the IG's report to determine the total amount of public benefits received for the projects and to identify the financial incentives received by the developers and investors. Your investigation, in particular, should highlight the amounts and sources of expected cash flows that could justify the payment of the consultant fees uncovered by the IG's report.

After consultation with the HUD IG's office, the Committee has preliminarily identified three projects for review. These include the Baltimore Gardens in Las Vegas, Nevada; Sierra Pointe in Clark County, Nevada; and the Pebble Creek Apartments in Arlington, Texas. I ask that the GAO work closely with the HUD IG's office to identify other projects to be included in your review.

Your investigation into this matter will greatly assist the Committee in fulfilling its oversight responsibilities and in our consideration of any programmatic changes to the Mod Rehab program. Should you have any questions regarding this request, please contact me or have a member of your staff contact Ted Rozeboom of the Senate Banking Committee staff at 224-9206.

Sincerely,

Don Riegle

Donald W. Riegle, Jr.
Chairman

Senator **Riegle**. Second, I've received a letter from Secretary Kemp responding to concerns that have been raised about this program. I will not take the time now to read his letter into the record, but it is a positive, affirmative letter outlining his concerns about the program and the steps he is taking to deal with it.

In fact, it's his intention, as it is ours, to work closely with the Department of Housing and Urban Development to clean up the situation and to make sure that whatever changes are needed are made.

We'll make both those letters part of the record and they will also be made available to members of the press who may want copies for their own use.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
THE SECRETARY
WASHINGTON, D.C. 20410-0001

May 16, 1989

Honorable Donald W. Riegle
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Riegle:

Thank you for your invitation to comment on the Inspector General's investigative report on the Section 8 Moderate Rehabilitation program.

I am disturbed by findings in the Report which indicate some fundamental flaws in the funding process of the Moderate Rehabilitation subsidy program. The IG's audit indicated that the selection and allocation process for Moderate Rehabilitation funds in previous years was undocumented, ignored existing standards and regulations, and was based on the perception and reality of favoritism and abuse of non-public information. Therefore, I have taken actions to uphold the integrity of HUD's funding programs and ensure that all HUD funding selections are made equitably and for the benefit of low-income families.

First, I have cancelled all Fiscal Year 1989 funding selections for the regular Moderate Rehabilitation program for which the HUD field offices and Public Housing Authorities (PHAs) have not yet executed an annual contributions contract. These cancellations will be followed by a new funding competition for an estimated 2,400 units. In addition, over 300 projects, going back to Fiscal Year 1985, including those for which contracts have already been executed will be audited in the next year for a review of the public housing authority selection process and the calculation of subsidized rent levels. Previous-year awards for which contracts with developers have not yet been executed are put on hold, pending further review.

Second, I have instructed the Office of Housing to develop new selection procedures for the Moderate Rehabilitation program to provide a new, competitive selection process for the allocation of available funds from fiscal year 1989. All PHAs which have had funds cancelled will be eligible to participate in the new competitive round without prejudice. The competition will proceed essentially as follows:

- The Department will prepare a Notification of Fund Availability (NOFA) to invite applications for the Fiscal Year 1989 Moderate Rehabilitation program. All program funds will be fair-shared to our Regional Offices based on a formula reflecting relative need. Twenty-five percent of the funds will be allocated for use in non-metropolitan areas.

  -- Only PHAs having the greatest need as measured by the formula used to allocate rental rehabilitation grant funds will be invited to submit applications.

  -- Field offices will rate and rank the applications using a checklist incorporating the five regulatory criteria (rehabilitation expertise, availability of financing, PHA administrative capability, rehabilitation and leasing timing potential, and overall feasibility). Headquarters will review applications only for consistency.

  -- PHAs that are selected will be required to hold a new competition for the units and the selection procedures will have to be approved by our HUD field offices.

It is my expectation that the NOFA will be published in the Federal Register in early June.

Finally, I have asked HUD's Office of General Counsel to review all existing governmental and Departmental ethics and personnel conduct laws and regulations to determine whether additional regulations are required of HUD employees involved in funding decisions. This review will also define prohibited conduct by recipients of HUD grants, loans, subsidies and other programs, and will include activities by their officers, representatives, agents or involved consultants. I have asked the Inspector General to continue to monitor the Moderate Rehabilitation program and other programs as needed.

I appreciate the opportunity to respond to the Subcommittee's interest in the Inspector General's report and to explain the steps we've taken to return fairness and equity to the allocation of critical housing subsidies so as to ensure that these programs benefit the low-income people and communities they are designed to serve. I look forward to further discussions with you regarding this matter.

A similar letter has been sent to Senator Garn.

Very sincerely yours,

Jack Kemp

Jack Kemp

The CHAIRMAN. During the last 5 months, the inspector general's office of the Department of Housing and Urban Development has issued a series of reports outlining their investigations into the mismanagement of our nation's housing programs under the Reagan Administration.

The IG's most recent report regarding the section 8 Moderate Rehabilitation Program has been widely reported in the national press and is the subject of this morning's hearing.

The Moderate Rehabilitation Program was enacted in 1978 to upgrade housing not meeting HUD's minimum quality standards by helping owners to make needed repairs costing at least $1,000 per unit but less than $6,500 per unit.

In those instances, the project owner did receive section 8 rental assistance guaranteeing the owner a fair market rent on each unit plus an amount to cover the cost of the rehabilitation itself.

At the outset, I want to thank all of our witnesses for appearing before the committee today. I understand that for many of you that you had to rearrange your schedules and the committee appreciates your willingness to do that.

But, given the magnitude of the concerns raised by the IG's report, I believe it is imperative to conduct this hearing today before the Senate adjourns later this week for the Memorial Day recess period.

The IG's report has already received a lot of national attention through such bold front headlines as "Audit sites abuses at HUD" in the Boston Globe, or "James Watt Hits HUD Bonanza," in our own Washington Times.

Secretary Kemp has responded swiftly and appropriately to the report by suspending action on pending projects until the review of the program has been completed and a new system is in place for approving mod rehab applications.

I commend Secretary Kemp for his decisive action on this matter. I believe the review should be given a very high priority within the Department so that the mod rehab assistance can be provided as it was intended with whatever reforms are needed, and be done as quickly as it can be.

One of the most startling findings from my review of the IG report has been the size of the consultant fees involved for these projects. As enacted in 1978, the Mod Rehab Program was intended to provide only a modest incentive for owners to finance small-scale rehabilitation with private financing. Yet, the IG's investigation indicates the developers were willing to pay consultants hundreds of thousands of dollars to influence the HUD selection process.

Such consultant fees are not an eligible product cost under the Mod Rehab Program. And such costs could have only been economically justified if the projects were to generate cash flows that were much larger than those that were intended by Congress.

The IG's report suggests the developers were allowed to distort the program so that it could provide guaranteed rent rolls for large projects that could then obtain other incentives such as tax-exempt bonds, low-income housing tax credits and financing under the HUD Home Insurance Program.

To help members of the committee understand the relationship between the Moderate Rehabilitation Program and other public benefits, such as the Low-Income Housing Tax Credit, I am asking the Comptroller General of the United States to review some of the projects highlighted in the Inspector General's report.

I want to determine the total amount of public benefits received for each project. And I want to identify the financial incentives that were received by the developers and the investors.

I believe this GAO review is necessary to uncover reasons for the very disturbing behavior that has been noted in the IG's report.

At this point, I want to yield to my colleagues for opening comments. Let me yield first to Senator D'Amato.

OPENING COMMENTS OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, first, let me commend you for calling the hearing. It's important that we learn what took place and how to correct the deficiencies.

I'm not going to be able to stay for the hearing as I have three others being held simultaneously. However, I would like to commend the Inspector General and his staff for putting together a well-balanced report on the serious deficiencies of the program.

I want to commend Secretary Kemp for his forthright action in responding to the serious situation so that we can continue those aspects of the program that deserve to be supported and not impinge upon the needs, the legitimate needs of people, and see to it that the process is opened up and we avoid this kind of favoritism that obviously existed as put forth by the Inspector General.

There's no doubt about that.

So, Mr. Chairman, it is disturbing but it's important that we focus on dealing with the reforms and implementing them as quickly as possible.

I would hope the Inspector General might have some recommendations in that regard so that the positive aspects of this mod rehab program can and should be retained, and those who are truly in need receive the funding on the basis of need and on the basis of the genuineness of their application, and that there be a system to see to it that they are prioritized on that basis, on the basis of fair competition.

I think that's what this Committee should be striving to achieve. I know that's something that you desire. And I'm going to ask that my statement be placed in the record as if read in its entirety.

PREPARED STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I regret that we must be here today to look into what has been a serious problem at the Department of Housing and Urban Development. The report of the Inspector General has created a great deal of discomfort with and skepticism about the activities of the Department. I, too, must express my concern about the favoritism and abuse which existed with the Mod Rehab Program over the past 5 years.

The IG report could not come at a worse time. The new administration at HUD has been accompanied by nothing but praises from Republicans and Democrats alike. Secretary Kemp has expressed an unprecedented commitment to tackling the tough housing problems. The low morale which has plagued the agency in the last 10–

15 years is evolving into a more positive and productive approach to implementing Federal housing programs. With so many positive changes taking place, it is unfortunate that past errors of neglect and abuse must surface.

Despite the unfortunate timing of this incident, I am committed to ridding the Department of Housing and Urban Development of any fraud or wrongdoing. Taxpayers deserve a fair and equitable allocation of Federal dollars. Communities around the nation, communities which have major housing problems, deserve to compete fairly to address their local housing needs.

The facts which surfaced in the Inspector General's audit were shocking. The report reveals that a significant amount of favoritism and abuse existed in the awarding of moderate rehabilitation contracts over the last 5 years. It is estimated that as much as $413 million in overpayments could have been made to developers and others.

Some private consultants—including former HUD employees—received substantial fees, of up to $1500/unit, for providing developers with special assistance in obtaining HUD funding. Advance notification of funding awards was made available to certain developers. Only certain developers and communities were invited to apply for the funding. Out of the more than 3,000 public housing authorities eligible to receive mod rehab funding, only 204 were invited to apply for the funding over the 5 year period. Finally, contract awards appear to be closely linked to contributions to a nonprofit charity, FOOD for Africa.

At a minimum, the facts are disturbing. At a maximum, they bring into question the ability of a large political bureaucracy to make decisions based on fairness and equity, entirely separate from political motivations or temptations.

Perhaps the sole glimmer of hope in the midst of this public tragedy is the response of Secretary Kemp to this abuse. The Secretary has made this issue a top priority. He has pulled back 35 out of 43 awards that were made through the Mod Rehab Program last year. This totals almost $200 million in mod rehab funds. In addition, he has announced that more than 300 projects that have already received rehabilitation funding through this program will be audited and that a new competitive process will be devised.

Secretary Kemp's quick response to this problem and his clear dedication to fairness give me hope for the potential of HUD to address and overcome this blight. I am committed to working with the Secretary to rid the agency of any fraud and abuse so that HUD may move on to fulfilling its true mission—to meet the serious housing needs of families around this nation.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator D'Amato.

Senator Bryan.

OPENING COMMENTS OF SENATOR BRYAN

Senator BRYAN. Thank you very much, Mr. Chairman. I'd like to associate myself with the comments you made in your opening statement as well as the comments made by Senator D'Amato.

Clearly, there were problems in this program. They need to be corrected. I, too, would commend the IG for calling it to the attention of the Congress and the actions taken by the Secretary to date.

I think the thrust needs to be how to correct this. There clearly is a vast need out there and this program needs to be run in a fair and responsible manner. And we're interested in hearing from the witnesses and their suggestions and comments as to how we can build the necessary protections into the program that apparently do not exist at the present time.

The CHAIRMAN.. Thank you, Senator Bryan.

Senator Shelby.

Senator SHELBY. Mr. Chairman, I have a written statement that I'd like to have included in the record. And subject to your approval, I'd like to go on ahead.

PREPARED STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I want to commend you for scheduling this hearing and for giving us an opportunity to explore in greater depth the recent allegations that the section 8 Moderate Rehabilitation Program has been mismanaged and consequently has cost the Government millions of dollars.

I have looked over the testimony. The Inspector General offers substantial evidence that the allegations are true. Frankly, I am disgusted. This committee has just completed extensive work on what is referred to as the S&L "bailout" bill, which inevitably, will cost the taxpayers billions of dollars, largely because of fraud. The words "Pentagon" and "scandal" have almost become synonymous over the years. And now we find that a hefty percentage of the few housing dollars that remain after 8 years of budget cuts have been wasted, used to line the pockets of consultants and developers. It is small wonder that the public's perception of the Federal Government is one of ineptitude and corruption.

Mr. Adams, you and your staff have done good work. However, your job is not finished. You must continue to work with the Justice Department to establish culpability. Those who are responsible should be prosecuted to the fullest extent possible.

The absence of accountability was an important factor in this situation. I understand from the testimony that HUD regulations were often ignored with little apparent recourse. Public housing authorities failed to comply with HUD handbook regulations, and made significant errors in calculating the rents and number of eligible units. This indicates that there was neither adequate oversight from HUD nor severe enough penalties to deter public housing authorities from submitting incorrect applications. While a marginal amount of error is probably inevitable, the pervasiveness of the error indicates that the problem is systemic.

This program is broke and we had better fix it. I get letters every day from constituents concerned over the homeless, over substandard housing, over unaffordable rents. I have to respond that we're doing the best we can with very limited resources in this time of budget deficits. And now we learn that the little money that is allocated is misspent because of fraud and favoritism. The taxpayers deserve more, much, much more for their money.

Secretary Kemp has displayed concern over this matter and I have confidence that he will make every effort to correct it. We must ensure that there is adequate oversight and supervision of HUD programs. HUD must issue reasonable, effective regulations and public housing authorities and other applicants must follow these regulations. And we cannot tolerate even the appearance of influence peddling by former officials. If former officials are permitted to actively lobby current officials, maybe we should go back to the fair share allocation process.

I appreciate the testimony of the witnesses and the work done by the Inspector General's office. I look forward to the question-and-answer period.

Thank you, Mr. Chairman.

The CHAIRMAN. Very good.

Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, frankly, I am troubled when there are reports of mismanagement in a federally-subsidized program. I'm deeply troubled today because the HUD Inspector General's findings show mismanagement of a program which is of course intended to provide rental subsidies so that affordable housing is available to poor families.

When Federal funds are not used in an economical, effective and efficient manner, taxpayers pick up the tab and programs are short-changed.

Overall, Mr. Chairman, it becomes a no win situation for the taxpayers and the families for whom the programs are intended.

According to the IG's audit, HUD officials unnecessarily approved high section 8 moderate rehabilitation subsidies. As we know, assisted housing programs have already taken more than a 70 percent reduction in funding since I came here in 1981.

They cannot afford to be mismanaged and continue to exist. The Moderate Rehabilitation Program was a good one; however, according to the IG's report, between fiscal 1984 and 1988, sweetheart deals were made at the expense of the taxpayers.

This greatly disturbs me, Mr. Chairman. I propose to my colleagues that we take a serious look at the IG's findings with the intent of eliminating abuses in the Mod Rehab Program.

Additionally, I propose that we do whatever is necessary to get the Mod Rehab Program back on the track for which it was created—to upgrade substandard rental housing and to provide rental subsidies for lower-income families.

In the meantime, however, I urge my colleagues, Mr. Chairman, not to throw out this baby with the bathwater.

The CHAIRMAN. Thank you, Senator Dixon.

Before we begin, I have statements from Senators Cranston and Sasser for insertion in the record.

STATEMENT OF SENATOR ALAN CRANSTON

Senator CRANSTON. Mr. Chairman, I thank you for calling this hearing on the HUD Inspector General's report on the Reagan Administration's mismanagement and influence peddling in the section 8 Moderate Rehabilitation Program.

I was a Member of this Committee in 1978, when the Moderate Rehabilitation Program was enacted. I know well that this program was well-designed to expand the supply of low-income housing with small amounts of Federal assistance. That objective was important then. It is even more important today.

In 1978, Congress recognized that many housing units that failed to meet HUD minimum quality standards could become decent, affordable housing for low-income people with relatively small improvements. Much of this housing was then and still is in the hands of people owning small numbers of units. So the Moderate Rehabilitation Program was created to provide these owners with modest incentives to upgrade their property with private financing.

The program worked very well for several years until 1983 when things began to go very wrong. For several years, we have been hearing disturbing rumors that high-ranking Reagan appointees at HUD were engaged in abuse of mod rehab and other programs designed to provide decent housing for the poor.

The Inspector General's report begins to shed light on what was going on—it confirms many of the alarming rumors. The report provides disturbing evidence of gross abuse of the public trust. The report shows what can happen when the nation's housing policy is placed in the hands of its own enemies.

Frankly, I am angered that, at a time when Federal support for low-income housing had been slashed to unconscionably low levels, top management at HUD apparently took so little care for the proper administration of the funds that were available to provide housing for the poor.

I am angered that those allegedly involved in this abuse were the very same people who led the fight to cut Federal support for low-income housing. It was apparently not enough that they withdraw housing assistance from poor people who needed it, they also allegedly had to tap the remaining funds for their own private enrichment when they left office.

I want to make sure that the Justice Department vigorously pursues any evidence of possible violations of criminal or civil law.

I note that some opponents of Federal support for low-income housing—some long time allies of these former HUD officials—are now claiming publicly that the abuses uncovered by the Inspector General's audit are endemic to all programs. That's not surprising. But it is a preposterous smear on the many people who administer housing assistance properly. What was allegedly done by this small number of HUD officials is alarming, it is unacceptable, and we should make sure it is not repeated.

To my mind, the clearest red flag in the report is the outrageously high amounts that were paid for consultant fees—paid apparently in the hopes of gaining mod rehab allocations. This is strong evidence that HUD permitted the program to become much more lucrative for participating developers than Congress ever intended. The committee should identify the amounts and sources of such cash flows.

I commend Secretary Kemp for his fast action to clean up the mess that was left for him in this program—and, I fear, in other programs as well. And I am pleased to read in this morning's Washington Post that he is making good progress in getting the mod rehab back in operation so that it will be available to the many sound efforts to expand the supply of decent, affordable housing around the country.

I look forward to working with you, Mr. Chairman, with other Members of Congress and with Secretary Kemp to move beyond the last 8 years—beyond this sorry chapter in our country's housing history—and to begin serving the urgent housing needs of American families once again.

Thank you.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, thank you for calling this hearing on this disquieting situation over at HUD. At a time when we are facing a national housing crisis, and we have only very scarce resources to deal with the crisis, it seems that some former HUD officials have used these scarce funds to pad their nests.

Here we have a situation where a good program designed to upgrade rental housing for use by low income families has been subverted.

HUD's own Inspector General's audit on the Mod Rehab Program indicates "little assurance that housing is being provided to those areas having the greatest need; and that limited program funds are being spent efficiently and effectively."

Mr. Chairman, I am pleased that HUD's Inspector General, Mr. Adams, is before us today. Mr. Adams testified last week in the House that the costs of the favoratism and the lack of competition that was exhibited in the awarding of these HUD contracts is high—over $413 million in potential excess Government assistance payments.

Moreover, former HUD and other administration officials received huge fees for facilitating these contracts. Indeed, one former Special Assistant to the Secretary received $1.3 million in fees. A former Secretary of the Interior received $300,000.

Obviously if consultants were paid such fees for facilitating the mod rehab grants, developers were making much more.

Mr. Chairman, I find this blatant favoratism reprehensible when it appears that most of the projects funded were wasteful—they were clearly not an efficient use of our scarce housing resources. Mr. Chairman, this is an issue that should be vigorously pursued by the committee. I look forward to today's testimony.

The CHAIRMAN. Mr. Adams, we are pleased to have you today. I know you are accompanied by high-level people who have worked with you.

Do you want to introduce them to us?

STATEMENT OF PAUL A. ADAMS, INSPECTOR GENERAL, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY ALVIN TUCKER, DEPUTY INSPECTOR GENERAL, JOHN H. GREER, DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDIT, PATRICK J. NERI, ASSISTANT INSPECTOR GENERAL FOR INVESTIGATION

Mr. ADAMS. Yes, Mr. Chairman. To my right, Al Tucker, my immediate Deputy. On my left is John Greer, Deputy Assistant Inspector General for Audit; and on my far left is Patrick Neri, the Assistant Inspector General for Investigation.

The CHAIRMAN. We'd like now to hear your statement, Mr. Adams.

Mr. ADAMS. With your permission, Mr. Chairman, I'd like to submit my statement for the record and briefly summarize it.

The CHAIRMAN. Very good.

Mr. ADAMS. On April 26th of this year, my office released an audit report on the Moderate Rehabilitation Program. That report concluded that there was little assurance that funds for the Mod Rehab Program were being provided for those areas of greatest need.

Furthermore, there was minimal or no documentation or accountability for the public housing authorities selected by HUD headquarters to receive the funding allocations until May 1988.

Moreover, we found that the PHA's selected builders without complying with the need for an effective competitive process, and often were in violation of their own administrative plan.

Also, HUD and the PHA staffs often abdicated their responsibilities to the developers, consultants and, in some cases, the mortgage lenders.

Our report pointed out that the headquarters selection process caused a significant shift in the program operations resulting in only about 204 of the approximately 3,000 PHA's received funding allocations during the 5-year period.

Ten States received 51 percent of all units where the fair share percentage would have been about 16 percent. Fifteen PHA's received four or more allocations each during the period, representing over 33 percent of all units allocated.

Former HUD officials and employees actively sought and participated as developers; consultants or lender representatives in at least 55 projects.

In addition, other conditions existed in 69 projects we reviewed, which indicated possible project-specific selections by headquarters. In 19 projects, we noted the developers approached the public housing authorities claiming that if the PHA's applied for units, an award would probably be made to them. In 25 projects, the developers paid consultants, some of them former HUD officials, for services that equated in part to lobbying HUD officials on the developers' behalf.

In 49 projects, the ultimate awards made by HUD for the PHA closely approximated the number of units owned or controlled by specific developers. These conditions fostered a widespread perception among PHA's that HUD's selection process was not governed by the regulatory criteria and that it favored certain PHA's, owners and developers.

FORMER HUD EMPLOYEES HAD ACCESS TO INSIDE INFORMATION

While the audit was in progress, we began an investigation. This action was based on allegations that units were allocated to specific projects or developers, some of whom were former HUD employees, with substantial fees of up to $1,500 per unit paid by developers to consultants, including former HUD employees for assistance in obtaining the units that former HUD employees had access to inside information and that participants in the program made contributions to charitable organization supported by Thomas Demery, then Assistant Secretary for Housing.

Our investigation disclosed numerous instances in support of these allegations.

For example, there were 312 units awarded to the Maryland Department of Economic and Community Development, which was the number proposed by Ms. Judith Siegel for Kingsley Park, a project in Essex, Maryland. Although Ms. Siegel also participated in the program as a consultant to other developers, James Watt, former Secretary of Interior, was paid $300,000 to act as a consultant on Kingsley Park.

Another example was the award of 160 units to Clark County Authority, Las Vegas, Nevada. Phillip Abrams, a former HUD Assistant Secretary and Under-Secretary, wrote a letter on May 10, 1986, to Ms. Debra G. Dean, then Executive Assistant to the Secretary, which asked that Clark County be awarded 160 units.

On May 22, 1986, HUD allocated those 160 units to Clark County, who, in turn, awarded the 160 units to the Sierra Pointe Apartments, a project which was developed by Winn Associates, a company in which Mr. Abrams had an interest.

We also found that large consulting fees were paid to former employees, including Joseph Strauss, former special assistant to the Secretary, who received at least $1.3 million; Gerald Kisner, former Deputy General Counsel, who received $282,500; and Michael Karem, former deputy assistant secretary for Multi-Family Housing, who received $420,000.

We also heard of instances where developers received information about the allocations before the PHA's were notified.

For example, J. Michael Queenan, former director of Housing Development in Denver, advised the director of the Richland Washington Housing Authority that they had been awarded units even before the Seattle Regional Office was notified by HUD headquarters.

In Dade County, Florida, we found evidence that developers and owners were receiving information on unit allocations even before notification by HUD or the PHA. Such information included copies of memoranda from Mr. Demery to the Regional Administrator relating to the allocation of units as well as the HUD forms assigning units and contract authority to the PHA.

Our investigation also confirmed that developers and other participants in the HUD program contributed $290,554 to FOOD For

Africa, a charitable organization in which Mr. Demery has served in an official capacity since 1985.

This amount represents 50 percent of the funds raised between January 1986 and 1988.

We also determined that Mr. Demery attended most of the fundraising events and made introductory remarks at some of the functions he attended.

Contributions to FOOD include $36,000 from Mr. Queenan, $15,000 from Mr. Strauss; $19,000 from Benton Mortgage Company, a co-insurance mortgagee on approximately 45 mod rehab projects; and $27,000 from Real Property Services Corporation, a major participant in HUD programs.

Mr. Chairman, at last week's hearings in the House, concerns were expressed regarding my statement that our investigation had found no evidence of criminal wrongdoing. While the situations described in our audit and investigation provide cause for indignation, my statement was based on consultation with the Public Integrity Section of the Department of Justice, which, in its preliminary opinion, concluded that the underlying facts did not indicate an apparent violation of Federal criminal statutes.

I would remind everyone that both the Public Integrity Section and the Office of Government Ethics are presently conducting a comprehensive review of our audit and investigation results and we are awaiting further guidance from them.

However, I decided to release our investigation report because in my judgment, the Department and the Congress need to act on the underlying issues, whether or not these situations are eventually determined to be criminal.

Concerns were also expressed last week about the fact that the investigation focused on Mr. Demery and did not give the same depth of attention to then Secretary Pierce and Deborah G. Dean.

Mr. Demery felt that he was unfairly singled out for public scrutiny, even though these officials were more responsible for the decision-making process than he was.

With regard to Ms. Dean and Secretary Pierce, I can only say that if Mr. Demery had provided us during our investigation with the same information he provided during the testimony last week, we would have also covered those issues.

However, during numerous interviews with both our investigative staff and audit staff, as well as personal discussions between myself and Mr. Demery, he did not disclose this information to us.

INTERVIEW WITH SECRETARY PIERCE

I have also been questioned regarding waiting until January 19, 1989, to interview Secretary Pierce about his role in the program. The impression was left that we did not involve Secretary Pierce in our investigation soon enough; however, I would like to point out that I had discussed our investigation with Secretary Pierce on several occasions, in early 1988.

I subsequently sent the Secretary two memoranda on this effort, one in May 1988, another in October 1988.

At no time during my discussions with the Secretary, Mr. Demery or other HUD officials, were we led to believe that Secretary Pierce played a direct role in the terms of which localities received funding allocations.

It wasn't until late 1988, in December, in fact, we received any indication that Secretary Pierce might have been contacted by a consultant. Because of the Christmas vacation period and the Secretary's schedule, it was not possible to get an appointment until late January to interview Secretary Pierce on the most serious of the allegations, namely, that John Mitchell had been paid $75,000 by Mr. Louie Nunn because he had contacts with HUD from the top/down, because Secretary Pierce was a friend of his.

Secretary Pierce denied John Mitchell has ever approached him concerning any HUD-related matters.

Thank you, Mr. Chairman. That concludes my remarks.

I will attempt to respond to any questions you may have, for me or for my colleagues.

[The complete prepared statement of Paul A. Adams follows:]

Statement of
Paul A. Adams, Inspector General
Department of Housing and Urban Development
Accompanied by Alvin Tucker, Deputy Inspector General,
John H. Greer, Deputy Assistant Inspector General for Audit
and Patrick J. Neri, Assistant Inspector General for Investigation
Before the Committee on Banking, Housing and Urban Affairs
United States Senate

May 17, 1989

Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear before you today to discuss our recent audit and investigation of the Section 8 Moderate Rehabilitation Program. Accompanying me today are Alvin Tucker, Deputy Inspector General, John H. Greer, Deputy Assistant Inspector General for Audit, and Patrick J. Neri, Assistant Inspector General for Investigation.

The purpose of the Moderate Rehabilitation Program (Program) is to upgrade substandard rental housing and provide rent subsidies for lower-income families. Our work revealed that the process for selecting Public Housing Authorities (PHA's) that received moderate rehabilitation funds, until May 1988, was undocumented and ignored existing standards and regulations. This combined with other events which I will describe more fully, led to a growing perception of favoritism.

Early in the review process we recognized potential criminal violations. Accordingly, we met with officials of the Department of Justice for the purpose of keeping them informed and obtaining guidance on the course of the investigation. The briefings with the Department of Justice continued throughout our investigation, and the results of our audit and investigation have been provided to the Public Integrity Section and FBI for their consideration. I have kept the Secretary advised and met with staff of the House Subcommittee on Housing and Community Development and the House Subcommittee on Employment and Housing on several occasions.

The results of our audit and investigative work disclosed that the Program was poorly managed by HUD Headquarters and the field offices. Weaknesses were numerous and significant, and covered the entire spectrum of Program activities. Problems were noted at the PHA's, developer, and lender levels.

The majority of the projects funded over the past 5 years were selected by PHA's without open competition and the funded PHA's/projects appeared to be concentrated in certain areas of the nation. Former HUD officials participated as developers, consultants and/or lenders in at least 55 of the projects funded. In other instances, other former government officials also acted in similar capacities.

We initiated our review based on prior audit results and on information from a variety of sources including staff members of the House Subcommittee on Housing and Community Development, confidential informants, PHA officials, government employees and scattered media stories. I might point out that all of these sources expressed concern regarding favoritism and possible "payoffs" to influence the allocations but, were unable to furnish any evidence to support their concerns. We pursued each lead provided by these sources during the course of our audit and investigation.

In order to conduct our audit and investigation, we had to first gather data regarding program participants. Because HUD had no systematic way of identifying developers, consultants and lenders involved in the program, our audit staff developed a questionnaire for the PHA's receiving funding for more than 25 units. The information received from PHA's, coupled with allegations cited previously, enabled us to target our audit work.

I would now like to discuss some details of the objectives, scope, and results of the audit and investigative efforts. First, I'll discuss the audit work that culminated in our report issued on April 26, 1989.

The audit was performed during the period March 1988 through December 1988, and generally covered activities from January 1, 1984, through November 30, 1988. In addition to our summary report, we have thus far issued 24 audit reports covering PHA activities, 7 reports covering Field Office activities and a report on a coinsurance lender. Ten additional PHA audits are in process.

The primary audit objective was to perform an overall evaluation of the Program to determine if it was administered in an efficient, effective and economical manner. The review was conducted at HUD Headquarters, HUD Field Offices, PHA's, and at the offices of owners, contractors and a coinsurance lender.

At HUD Headquarters, we evaluated whether HUD:

- Selection of PHA's for funding complied with the appropriate regulations.

- Guidance and policies were sufficient to aid PHA's in administering the Program.

- Management gave sufficient attention to sound internal controls in administering the Program.

During the Headquarters phase of the audit we interviewed all former Assistant Secretaries or equivalents and most of their key staff involved in Program activities during the audit period.

At Field Offices, our objectives were to determine whether staff:

- Received appropriate training.
- Performed required monitoring reviews of PHA's.
- Approved PHA rent calculations.

Our work at PHA's was designed to determine if PHA's complied with HUD requirements and their own Administrative Plans in:

- Selecting owners to participate.
- Determining project feasibility and unit eligibility.
- Calculating contract rents.

As part of the PHA audits, we also performed selected audits of owners' certified project costs and contractors' rehabilitation costs. In addition, we audited the procedures followed by a coinsurer in underwriting 14 HUD-insured mortgages for moderate rehabilitation projects.

At this point, I think it would be appropriate to provide a brief overview of the Program to better assist you in understanding the audit results.

The Moderate Rehabilitation Program is authorized by Section 8 of the U.S. Housing Act of 1937, as amended. HUD aoproves program participation by, and allocates funding to, eligible PHA's.

The purpose of the Program is to upgrade substandard rental housing and to provide rental subsidies for lower income families. A minimum expenditure of $1,000 a unit is required, including the prorated share of work to be accomplished on common areas or systems. The expenditure is intended to: (1) upgrade the unit to comply with the Housing Quality Standards (HQS) approved by HUD from a condition that is below those standards (improvements other than routine maintenance); or (2) repair or replace major building systems or components in danger of failure. Units occupied by families not eligible for housing assistance are not eligible for inclusion in the Program.

PHA's receive funding allocations from HUD. During most of our review period, HUD allocations were made under the Headquarters Reserve process because Congress each year waived the "fair share" allocation process. The "fair share" process was designed to distribute funding to localities throughout the nation in line with "needs based formulas" developed by HUD's Office of Policy Development and Research. The HUD regulations governing the Headquarters Reserve process provide that when application demand exceeds all approvable applications, HUD will rank the applications based on its assessment of which applications have the best combination of the following five enumerated criteria: (1) demonstrated capacity of the PHA or its contractors to provide required rehabilitation technical assistance to owners; (2) availability of financing resources; (3) the PHA's experience with the Section 8 existing housing program or the PHA's overall administrative capability; (4) the potential of expeditious achievement of rehabilitation and leasing the unit; and (5) the overall feasibility of the proposed program. This competitive process is designed to provide funding to PHA's that are well suited to carry out the Program.

After an allocation is made to a PHA, HUD enters into an Annual Contributions Contract with the PHA spelling out the amounts and terms of the funding arrangement. The PHA then conducts a local competition by soliciting applications from owners or developers to determine which units are feasible for inclusion in the Program.

For units determined eligible, the PHA and owners execute an Agreement to Enter into a Housing Assistance Payments Contract. When the units are rehabilitated and the work accepted by the PHA, the Housing Assistance Payments Contract is executed for a term of 15 years. The owner receives a contract rent that is defined as the total rent including the rent paid by the family.

During the audit period about 35,780 units were funded representing Contract and Budget Authority totaling about $225 million and $3.4 billion, respectively.

Based on our audit results, we concluded that there is little assurance that housing is being provided to those areas having the greatest need; and that limited program funds are being spent efficiently and effectively. There was minimal or no documentation or accountability for the PHA's selected by HUD Headquarters to receive funding allocations. Moreover, PHA's selected developers without complying with the need for an effective competitive selection process and often in violation of their own Administrative Plans. There was an absence of clear written policy and guidelines. This fact, coupled with the evolution of the Program into a large-scale development program, caused the following problems: (1) PHA's were ill-equipped to determine effectively the nature and extent of rehabilitation work needed or the rent levels required to make projects feasible and economical; (2) HUD staff similarly were neither made available nor well prepared to monitor PHA activities and render needed technical assistance; and (3) HUD and PHA staff abdicated their responsibilities to developers, consultants and, in some cases, mortgage lenders.

There is little assurance that units were allocated to PHA's equitably or that the projects were selected competitively. This situation is largely responsible for the widespread perception that exists among program managers and participants alike that the Program is a Headquarters-driven program favoring certain PHA's, owners, developers, etc.

Our report pointed out that the Headquarters selection process dictated a significant shift in program operations that set the stage for many of the Program weaknesses. Key points and applicable references are:

- Only about 204 of the approximate 3,000 PHA's received funding allocations during the five-year period. (Appendix A)
- Ten States received over 51 percent of all units whereas their fair-share needs percentage, as developed by HUD, was only about 16 percent. (Appendix B)
- Fifteen PHA's received four or more allocations each during the period, representing over 33 percent of all units allocated. (Appendix C)
- Former HUD officials and employees actively sought and participated as developers, consultants or lender representatives in at least 55 projects. (Appendix D)

In addition, our report cited various conditions that existed in 69 projects we reviewed, which indicated possible project-specific selections by Headquarters. Specifically:

- In 19 projects, we noted that developers approached PHA's claiming that if the PHA's applied for units, an award would probably be made for them.
- In 25 projects, the developers paid consultants, some of whom were former HUD officials, for services that equated in part to lobbying HUD officials on the developer's behalf.

- In 49 projects, the ultimate awards made by HUD and/or the PHA closely approximated the number of units owned or controlled by a specific developer.

These conditions demonstrate the absence of the type of open competition at the PHA level intended in HUD regulations. The conditions also fostered a widespread perception among PHA officials that HUD's selection process was not governed by the regulatory criteria.

The costs, in terms of dollars and program integrity, are extremely high. As mentioned earlier, PHA's and HUD staff were ill-equipped to administer the Program and compute contract rents properly. At 15 of the 20 PHA's audited, we found that potential overpayments existed. These overpayments were caused by the PHA's failure to comply with HUD handbook requirements. This was further compounded by HUD's failure to (1) update and improve the written guidance covering rent calculations, and (2) provide technical assistance and monitor PHA's operations. Our audit noted that PHA's in calculating rents (1) included ineligible units; (2) allowed ineligible rehabilitation costs; (3) used incorrect data; and (4) made mathematical errors.

Excessive housing assistance payments will total $58.8 million during the 15-year contract terms for the 43 projects we reviewed at 20 PHA's in 7 different regions. (Appendix E) Using all units included in the 20 PHA's audited, as a universe (i.e., 5,099) this comes to an average of $11,544 per unit in potential overpayments. Multiplying the $11,544 by all units (35,780) allocated during Fiscal Years 1984 through 1989, as of November 30, 1988 our audit cut-off date, we arrived at total potential overpayments of $413 million. This is a realistic estimate since we believe our test results are indicative of the conditions at other projects funded over the past 5 years. I might point out that the PHA's audited, varied in size, staffing, location, etc., yet all appeared to experience similar systemic problems. Additionally, our ongoing audit work at 10 additional PHA's in 6 regions indicates that the same problems are occurring. With regard to program integrity, HUD staff as well as PHA officials have little confidence that the Program is administered in an economical, effective or efficient manner.

We attribute the Program's current condition to a lack of commitment on management's part to provide attention to those areas needing it most. For example, the program regulations were not revised to keep pace with program policy and actual program practice. Handbooks, directives and other written guidance became a patchwork collection of unrelated and unclear instructions for both HUD staff and PHA program people. Numerous shifts occurred within the HUD offices regarding responsibility for the Program. Adequate staffing and training resoures were not provided. All these factors tended to confuse or blur the lines of authority and resulted in essentially no accountability.

Concerted efforts are needed to overcome the reported weaknesses. Staff resources need to be allocated and given priority assignments in order to recover overpaid assistance, to adjust contract rents to their proper levels, to monitor ongoing PHA activities, and to upgrade program guidance and regulations. HUD managers have already taken, or agreed to take, steps to resolve 19 recommendations in our audit report. We are impressed by management's reaction to our report and we will work closely with them in assuring that appropriate corrective actions are taken.

While the audit was in progress, we began an investigation because of indications that the allocation process for the Program was not competitive and a strong perception of favoritism existed. This was based on the apparent allocation of units to specific projects or developers, some of whom were former HUD employees; the payment of substantial fees of up to $1,500 per unit by developers to consultants, including former HUD employees, for assistance in obtaining the units; the apparent access to inside information by former employees; and the contributions by participants in HUD programs to a charitable organization supported by Thomas Demery, then Assistant Secretary for Housing-Federal Housing Commissioner.

Developers, consultants, and PHA employees were interviewed concerning projects that were awarded Program units. This was combined with our efforts to gather information on contributions to the charitable organization, as well as fees paid to former HUD employees for consulting work. We subpoenaed records and interviewed those who agreed to meet with us. We were unable to interview certain former employees who declined to be interviewed. I would like to point out that we cannot compel someone to be interviewed.

Our investigation disclosed a definite perception that favoritism existed in the allocation process. Contributing to this perception were frequent instances where the number of units awarded coincided with the specific number of units proposed by certain developers. For example, there were 312 units awarded to the Maryland Department of Economic and Community Development, which was the number proposed by Ms. Judith Siegel for Kingsley Park, a project in Essex, Maryland. Although, Ms. Siegel also participated in the Program as a consultant to other developers, James Watt, former Secretary of Interior, was paid $300,000 to act as consultant on Kingsley Park. Another example was the award of 160 units to the Clark County Housing Authority (CCHA), Las Vegas, Nevada. Philip Abrams, former Assistant Secretary for Housing and former Under Secretary, wrote a letter on May 10, 1986 to Ms. Deborah G. Dean, then Executive Assistant to the Secretary, which asked that the CCHA be awarded 160 units. On May 22, 1986, HUD allocated 160 units to CCHA, who in turn, awarded the 160 units to Sierra Pointe Apartments, a project which was developed by Winn and Associates, a company in which Mr. Abrams had an interest.

Our interviews of PHA officials and others indicate that it was their perception that developers were being awarded units as a result of fees paid to consultants including Joseph Strauss, former Special Assistant to the Secretary, who received over $1,300,000; Gerald Kisner, former Deputy General Counsel, who received $282,500; and Michael Karem, former Deputy Assistant Secretary for Multifamily Housing, who received $420,000. A list of consultants identified during our work, and fees earned is attached as Appendix F.

We also found instances where developers received information about the allocation of units before the PHAs were notified. For example, Mr. J. Michael Queenan, an associate of Winn and Associates and a former Director of Housing Development, HUD Denver Regional Office, advised the Director of the Richland, Washington Housing Authority of the award of units even before the Seattle HUD Regional Office was notified by HUD Headquarters. In Dade County, Florida, we found evidence that developers and owners were receiving information on unit allocations to PHAs even before notification to the PHA. Such information included copies of memoranda from Mr. Demery to the HUD Regional Administrators detailing the allocation of units, as well as the HUD forms assigning funding and contract authority to the PHA.

Information was developed during the audit indicating that a developer contributed to F.O.O.D. FOR AFRICA (FOOD), a charitable organization listed on Mr. Demery's Financial Disclosure Statement for which he served in an official capacity since 1985. While we found no reason to question the stated purpose of FOOD, we identified contributions totalling $290,554 that were made to FOOD by participants in HUD programs between January 1986 and 1988. This amount represents 50 percent of the funds raised during the same period. Mr. Demery served as Secretary for FOOD until October 1986 when he began his HUD employment. While initial fundraising efforts were targeted at religious congregations, Mr. Demery and others later directed the fundraising efforts toward business and commercial enterprises. We were able to determine that Mr. Demery attended most of the fundraising events and made introductory remarks at some of the functions he attended. The events were sponsored by various individuals and companies, including certain participants in the HUD programs such as Michael Karem and J. Michael Queenan. Contributions to FOOD included $36,000 from Mr. Queenan; $15,000 from Joseph Strauss; $19,000 from Benton Mortgage Company, a co-insurance mortgagee on approximately 45 Mod Rehab projects; and $27,000 from Real Property Services Corporation, a major participant in HUD projects. In June 1988, Mr. Demery sought to obtain General Counsel approval for a letter endorsing FOOD utilizing his official title and Departmental letterhead. His request was declined. On November 21, 1988, I provided some preliminary information on our investigation to Mr. J. Michael Dorsey, then General Counsel, for a preliminary opinion on possible Standards of Conduct violations. Mr. Dorsey responded on December 12, 1988 that no violations had occurred.

As I stated earlier, our Report of Investigation is still under review by the Public Integrity Section of the Department of Justice.

Secretary Kemp has taken an active interest in our Office and met with me immediately upon arriving at HUD to learn first-hand of significant on-going audits and investigations. I provided him details of these efforts at that time. He and his staff have responded quickly and positively to our report. In early March, we provided our draft audit report to the Office of Housing for review and comment. We also provided Secretary Kemp with summaries of the report findings. In mid-April, we provided Secretary Kemp with our report on investigation.

On March 31, 1989, the Office of Housing provided outlines and target dates for steps to be taken to resolve 19 audit recommendations. Secretary Kemp sent memoranda to top program managers in the Field and Headquarters that summarized the problems we identified, and explained his commitment to taking corrective actions.

On April 26, 1989, Secretary Kemp announced a series of actions he took to assure that HUD funds benefit the most deserving recipients. More specifically, he announced that:

- All FY 1989 funding selections were canceled for those PHA's that had not yet executed an Annual Contributions Contract.
- Over 300 projects funded during the audit period will be reviewed by HUD staff to determine if the projects were selected properly and the rent rates were computed accurately.
- A new selection process will be developed by the Office of Housing and will be used to reallocate the canceled FY 1989 funds.
- The Office of General Counsel will review existing rules and laws to determine whether new regulations are needed to govern HUD employees' involvement in funding decisions. This review will also define prohibited conduct by recipients of HUD grants, loans, subsidies and other programs.

Secretary Kemp and his staff have responded positively and appropriately to our audit and investigative reports. I am confident that his personal commitment to strengthening the Program's effectiveness will significantly improve the economy and efficiency of the Program and restore public confidence and program integrity. We look forward to working closely with Secretary Kemp in this regard.

This concludes my remarks and I appreciate your attention.

APPENDIX A

SCHEDULE OF FUNDING ALLOCATIONS
BY REGIONAL OFFICE
FISCAL YEARS 1984 - 1988

		UNITS PER ALLOCATION				
REGION	ALLOCATIONS	UNDER 25	25 - 49	50 - 99	100 & OVER	PHAs RECEIVING ALLOCATIONS
1	26	3	4	11	8	13
2	35	2	4	9	20	24
3	49	16	10	10	13	28
4	60	2	7	17	34	36
5	34	3	3	8	20	17
6	35	1	3	14	17	34
7	10	2	1	1	6	9
8	32	4	4	14	10	14
9	21	1	3	4	13	14
10	16	3	9	2	2	15
TOTALS	318	37	48	90	143	204
PERCENTAGE OF ALL ALLOCATIONS	100	11.6	15.1	28.3	45	

APPENDIX B

SCHEDULE OF FUNDING ALLOCATIONS NOT CONSISTENT WITH FAIR SHARE PERCENTAGES (WHERE DIFFERENCES EXCEED 1.0 PERCENT) FISCAL YEARS 1984 - 1988

STATE	PERCENTAGE OF FUNDS ALLOCATED	FAIR SHARE PERCENTAGE	EXCESS FUNDING (UNDER) FUNDING
FLORIDA	15.15	3.3	11.85
PUERTO RICO	6.91	1.0	5.91
COLORADO	4.63	1.0	3.63
OKLAHOMA	4.05	.9	3.15
VIRGINIA	4.40	1.9	2.50
NEVADA	2.85	.4	2.45
DISTRICT OF COLUMBIA	2.30	.7	1.60
UTAH	1.72	.4	1.32
ILLINOIS	6.36	5.1	1.26
LOUISIANA	2.75	1.5	1.25
SUBTOTALS	51.12	16.2	34.92
CALIFORNIA	4.94	16.6	(11.66)
NEW YORK	2.66	13.6	(10.94)
PENNSYLVANIA	1.83	3.8	(1.97)
MICHIGAN	1.45	2.7	(1.25)
MINNESOTA	.24	1.4	(1.16)
INDIANA	.22	1.3	(1.08)
SUBTOTALS	11.34	39.4	(28.06)

SCHEDULE OF PHAs RECEIVING
FOUR OR MORE FUNDING ALLOCATIONS
FISCAL YEARS 1984 -1988

PHA	NO. OF ALLOCATIONS	NO. OF UNITS	AVERAGE UNITS PER ALLOCATION
DADE CO - DSHP, FL	14	2,879	206
RICHMOND RHA, VA	9	982	109
ILLINOIS HDA	6	968	161
COLORADO HFA	6	773	129
NEW JERSEY DCA	4	753	188
DISTRICT OF COLUMBIA HCD	4	673	168
MASSACHUSETTS EOCD	8	673	84
OKLAHOMA HFA	4	659	165
CHICAGO HA, IL	4	646	161
MICHIGAN SHDA	6	527	88
SAN DIEGO HC, CA	4	433	108
SHREVEPORT HA, LA	4	310	77
DENVER HA, CO	4	203	51
PHILADELPHIA HA, PA	6	166	28
MONTANA DOC	4	150	38
TOTALS	87	10,795	124

APPENDIX D

SCHEDULE OF FORMER HUD EMPLOYEES
PARTICIPATING IN MRP

POSITION HELD AT HUD	NO. OF PROJECTS PARTICIPATED IN AS:		
	OWNER/DEVELOPER	CONSULTANT	FEE BASED LENDER REP
Undersecretary	6		
Asst. Secretary for Housing	7		
Executive Asst. to Secretary	6		
Special Asst. to Secretary		13	
Deputy Asst. Secretary for Hsng.		3	
Special Asst. to Asst. Secy. for Hsng.		2	
Deputy General Counsel		3	
Regional Administrator	2	2	2
Regional Director for Hsng. Mgmt.	20	3	12
Regional Financial Mgmt. Specialist	4	3	19
TOTALS	45	29	33

Several individuals were involved in the same projects. About 55 separate projects were noted where a former HUD employee participated.

LIST OF PHAs AUDITED

WITH POTENTIAL OVERPAYMENTS (15 YEARS)

REGION	PHA	NUMBER OF UNITS	NUMBER OF PROJECTS	POTENTIAL OVERPAYMENTS
1	Holyoke, MA HA	100	1	
	Portland, ME HA	100	1	
	Lynn, MA HA	117	1	$ 2,479,140
	Vermont State HA	134	2	
	Worcester, MA HA	39	1	$ 258,660
	Massachusetts EOCD/RHI	161	2	$ 1,614,060
	Massachusetts EOCD/HAP	516	8	$ 9,194,580
2	Municipality of Bayamon, Puerto Rico	180	1	$ 5,637,600
	N.Y. State HFA	316	1	
3	Maryland Dept. of ECD 1/	312	1	$ 4,021,000
	Richmond Redevelopment and Housing Authority	631	3	$ 1,771,200
	Prince George's County	172	1	$ 1,499,400
4	Dade Co. Dept. of SHP	846	7	$ 5,147,781
5	Chicago, IL HA	483	4	$ 3,420,720
	Michigan SHDA	282	3	$ 1,703,520
7	St. Louis, MO HA 2/			
	HA St. Louis County	228	1	$ 6,764,580
9	San Diego, CA HC	121	1	$ 851,400
	Las Vegas, NV HA	201	2	$ 9,563,760
	Clark County, NV HA	160	1	$ 4,934,340
	TOTALS	5,099	42	$58,861,741 3/

1/ Based on Survey Report dated March 1, 1988. Final audit work pending completion of rehabilitation work.

2/ Survey work showed project to be infeasible. Project was terminated prior to AHAP.

3/ Amount equates to $11,544 per unit over the 15-year contract term.

APPENDIX F

NAME AND POSITION	NO. OF PROJECTS PARTICIPATED IN AS: OWNER/ DEVELOPER	CONSULTANT	CONSULTANT FEES
Philip Abrams, Under Secretary	6		
Philip Winn, A/S for Housing	7		
Lance Wilson, Exec. Asst. to the Secretary	6		
Joseph Strauss, Spec. Asst. to the Secretary		13	$1,305,875
Michael Karem, Deputy A/S for Multifamily Housing		3	420,000
Rick Price, Spec. Asst. to A/S for Housing		2	125,149
Gerald Kisner, Dep. General Counsel		3	282,500
Ronald Gatton, Regional Administrator (Chicago)	2	2	94,000
J. Michael Queenan, Reg. Dir., Housing Mgmt. (Denver)	20		
Runny Mahon, Reg. Financial Management Specialist	4		
R. Carter Sanders, Deputy Assistant Secretary			107,000
			$1,946,524

OTHER CONSULTANTS - NON-HUD

Edward Brooke	$ 183,000	
Fred Bush & Co.	260,000	($65,000 outstanding balance)
Louis Nunn	375,000	(includes attorney fees of $225,000)
Judith Siegel	351,000	
James Watt	300,000	
Rick Shelby	442,000	
	$1,911,000	

The **CHAIRMAN**. You've put some very important information on the record already, and we'll get into it.

I want to call on some other members of the committee for the purpose of delivering opening statements.

I want to call on Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **GARN**. Thank you, Mr. Chairman.

Mr. Adams, I apologize for not being here at the outset of your testimony. I have two markups going on, one in Rules and one in Energy, and I'm trying to help to make quorums in both. I've still got to go back to Energy and, hopefully, they can get a quorum on natural gas deregulation.

Mr. Adams knows something that the rest of you don't know. He appeared yesterday before the HUD and Independent Agencies Subcommittee of Appropriations. Although I did not hear his testimony this morning, I heard it yesterday and had the opportunity to question him, both Senator Mikulski and I, at great length in that hearing yesterday afternoon.

Therefore, it is not as important for me to do it and I would not subject you to the same questions again today as I did yesterday.

I want you, Mr. Chairman, and the rest of the committee to be aware that I already had my go at him yesterday.

Thank you very much, Mr. Chairman, and I will return to my committee.

The **CHAIRMAN**. Thank you, Senator Garn.

Senator Graham.

OPENING STATEMENT OF SENATOR GRAHAM

Senator **GRAHAM**. Mr. Chairman, I wish to commend you for scheduling these very important hearings. They go to the core of public confidence in an important Government program that this committee has given considerable priority to, particularly through the leadership of Senator D'Amato and Senator Cranston, to the whole issue of a revitalized housing program for America.

That revitalization must start from a foundation of basic public confidence in the way in which the current programs are being administered.

I hope today that we prove to be good diagnosticians in trying to understand what has happened and maybe the physicians themselves can provide some directions that will heal this hemorrhage.

The **CHAIRMAN**. Thank you, Senator Graham.

Senator Pressler.

Senator **PRESSLER**. Thank you, Mr. Chairman. They are screaming at me to get to Foreign Relations to form a quorum to finish markup. So I'm going to put an opening statement into the record, if I may.

I also wanted to say on a personal note that Fred Bush will be testifying later this morning. I'll try to come back for that. But, I know Fred Bush is a person of great integrity. He served as Under-Secretary for Tourism when I served as Chairman of the Tourism Subcommittee in this Senate.

I've known him for a number of years and I can assure you that he is as honest as he is long and round. And I also know Senator Brooke, and I also welcome him here. And I hope to get back for his words.

But I just wanted to say how much I think of Fred and Ed Brooke, whom I both know personally.

Mr. Chairman, with the Chairman's consent, please place my statement in the record. I shall return.

OPENING STATEMENT OF SENATOR LARRY PRESSLER

Senator **Pressler**. Thank you. Mr. Chairman, I wish to commend you for scheduling this hearing on the report of HUD's Inspector General with respect to the management of the Section 8 Moderate Rehabilitation Program. Whenever we have a documented report of mismanagement in Government such as that now before us, the cognizant committees of the Congress should conduct oversight hearings to determine whether there has been mismanagement and whether remedial action should be taken or legislation proposed in order to curb the abuse. In my view it makes no difference where the fault may lie.

Apart from other findings, the Inspector General reports that incorrect rent calculations will result in HUD paying excessive housing assistance totaling nearly $60 million during the 15-year contract terms for the projects reviewed. This further indicates a possible excess assistance approaching $413 million over the contract term.

Mr. Chairman, Federal assistance in housing is far too vital an activity for us to condone mismanagement or wrongdoing in its administration. So I commend you for promptly scheduling the hearing. I shall be most interested to hear and read the testimony of the witnesses in this matter.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Pressler.

Let me now raise questions with you, Mr. Inspector General.

First of all, I assume you have had all the resources you feel you need to pursue this inquiry?

Mr. **Adams**. Yes, sir, we have. In fact, we expended about 15½ staff years doing the audit, about 2½ staff years doing the investigation. And we still have some ongoing work.

The **Chairman**. At any time, did anybody in any way try to push you off course or try to keep you from doing exactly what you felt you needed to do?

Mr. **Adams**. Never, sir.

CONTRADICTORY STATEMENTS

The **Chairman**. What did Mr. Demery say in the House Committee last week that came as a surprise to you, that he had not told you before?

Mr. **Adams**. He defined the role of Ms. Dean and Secretary Pierce as being much greater than we'd ever been led to believe before in the selection of the localities.

The **Chairman**. Did you ask him those questions previously?

Mr. ADAMS. He was interviewed on several occasions and he always portrayed the situation as being more of a committee process, which he led, making no specific recommendations for the selections or input into the process.

The CHAIRMAN. To be very frank about it, do you have the sense that he just changed the description of things when he testified before the House?

Sounds to me like he told you one thing at one time and now he's changed that story.

Mr. ADAMS. It seems to be that way, sir.

The CHAIRMAN. In a situation like that, what legal authority attaches to you? If you quiz someone, they give you false answers and they later change their story, what steps are you empowered to take in a case like that?

Mr. ADAMS. Witnesses are under no compulsion to first of all appear or be interviewed by us, and we have no process by which to compel them to reconcile contradictory statements that they may make.

The CHAIRMAN. So, if someone tells you a false story and it later comes to light, all you can do is really make it public and, in effect, you are doing that today?

Mr. ADAMS. That's correct. The Department of Justice would have the ultimate authority to decide whether or not there was a material/false statement that might be subject to some criminal penalties.

The CHAIRMAN. In essence, I would like you to put a little sharper point on what Mr. Demery said last week with respect to the role of Ms. Dean and the Secretary.

Mr. ADAMS. Specifically, he would say that early in the process, when he first became Assistant Secretary, he was basically told which PHAs to select by Debra Dean, speaking on behalf of the Secretary.

The CHAIRMAN. The audit report found that several well-connected consultants were paid these very substantial fees.

For the record, I want to list a number of the consultants that have been identified by the report, and I want to have you tell the Committee about the nature and extent of each individual's involvement in the Mod Rehab Program.

Also, I want you to tell us the fees that were earned by these individuals, and whether or not they did earn these fees.

Let me start with Secretary Watt, former Secretary of the Interior.

FEES EARNED FROM PROJECTS

Mr. ADAMS. Mr. Watt received $300,000 as a fee on one project. When interviewed, Mr. Watt contends that his role was basically to make contacts with the right people to convince them it was a worthwhile project.

The CHAIRMAN. Do you have any sense of what work he did? What was involved? Was it a series of meetings, trips, for phone calls?

Mr. ADAMS. That was about the extent of the testimony he provided to us.

The CHAIRMAN. You have no ability to compel a more complete answer?

Mr. ADAMS. No, sir.

The CHAIRMAN. So he received $300,000 for one project. Is that right?

Mr. ADAMS. That's correct, sir.

The CHAIRMAN. How big was that project?

Mr. ADAMS. 312 units.

The CHAIRMAN. 312 units. All right.

Another witness that we'll have later this morning, former Senator Ed Brooke, a former member of this committee and a good friend to many of us on this panel, what did Mr. Brooke receive?

Mr. ADAMS. He received $183,000 for two projects.

The CHAIRMAN. Where were those projects?

Mr. ADAMS. Both were located in the State of Massachusetts. One in Lynn, Massachusetts and the other in Worcester, Mass.

The CHAIRMAN. The next individual, Richard Shelby? No relationship.

Senator SHELBY. Mr. Chairman, if you will yield, I want you to make that clear. [Laughter.]

That Richard Shelby is a Republican from Oklahoma and I'm a Democrat from Alabama. We don't want to get our names mixed up, or our roles either.

The CHAIRMAN. I fully agree, Senator Shelby. The Richard Shelby that was involved in this program, as I understand it, was a former aide in the Personnel Office under President Reagan.

Is that correct?

Mr. ADAMS. I believe that's correct, sir.

The CHAIRMAN. What did that individual receive?

Mr. ADAMS. He received $442,000 in connection with two projects.

The CHAIRMAN. Where were those projects?

Mr. ADAMS. One was located in Maryland, and one was located in Florida.

The CHAIRMAN. Again, do you have any very complete sense as to what any of these individuals—and I'm going to finish the list here—did to earn these fees?

Mr. ADAMS. In the situation with Mr. Shelby, his role had always been to focus on political relationships and contacts in Government.

The CHAIRMAN. It sounds like he was pretty good at it.

Mr. ADAMS. He disclaimed any specific knowledge with respect to any of the programs.

The CHAIRMAN. He disclaims specific knowledge with respect to the programs?

Mr. ADAMS. Yes.

The CHAIRMAN. Mr. Fred Bush—I take it no relationship to the President, but identified as a prominent fund-raiser for the Republican Party—what did Mr. Bush receive?

Mr. ADAMS. Bush or his firm received $260,000 in connection with a project in Puerto Rico.

The CHAIRMAN. In Puerto Rico. Another witness whom we'll hear from today, Judith Siegel, who is a developer in the Mod Rehab Program, how much did Ms. Siegel receive?

Mr. Adams. She received a total of $474,000 in connection with four projects. I might point out, that in my earlier testimony, I said $351,000, but we'd overlooked one project in the aggregation of those.

The Chairman. Where were those located?

Mr. Adams. One in Massachusetts, two in Vermont and one in North Carolina, sir.

The Chairman. Mr. Joseph Strauss is identified as the former Executive Assistant to Mr. Pierce. What did Mr. Strauss receive?

Mr. Adams. Mr. Strauss received $1.3 million for 13 projects.

The Chairman. Can you give me for the record where those projects were? Were they clustered in one State or were they around the country?

Mr. Adams. I think they were in several different locations, including Puerto Rico and Florida, but we'll provide a complete listing for the record.

[Information furnished:]

State	Number of projects	Verified fees
Massachusetts:		
Laurel Apartments	4	$130,000
City Wide Apartments	1	179,875
Hollywood Apartments	1	309,000
State and Terrence Street Apartments	1	26,000
New Jersey: Cityside Apartments	1	(1)
Florida: West Dade Ltd	1	100,000
Puerto Rico:		
Ceiba	1	
Vega Baja	1	605,000
Fajardo	1	
Humacao	1	
Total	13	1,349,875

[1] We did not obtain copies of contract or payments.

The Chairman. It looks to me like he's the guy who really hit the jackpot; as far as we have identified individuals who have made the most money off these fees, he seems to be at the top of the list. Am I correct?

Mr. Adams. That's correct, sir. I'd just like to clarify one point. This does not represent all the consulting fees. This only represents what we discovered during the process of our audit work. And we have reason to believe that there are other consulting fees out there. It's only a sample.

The Chairman. That's a very important fact. You have reason to believe that there are other consulting fees through the Department of Housing and Urban Development or through other Cabinet Agencies?

Mr. Adams. No, in connection with this program.

The Chairman. In connection with this program, you don't think you've got all of the ones identified with respect to Mr. Strauss, for example?

Mr. Adams. We have no way of knowing.

The Chairman. Is there no central record file that would allow you to track all this down?

Mr. ADAMS. Well, you might recall this is a locally-administered program, so the relationship with the consultant is with the developer at the local level, so that information does not appear in HUD records.

When we first began our audit work, we had to send a questionnaire to the local public housing authorities and get some information. We've been doing work at both the public housing agencies and the developers. Each time, we discovered these fees.

The CHAIRMAN. I think we need to determine a way to go out and reconstruct all of this activity so we find out every last penny that went to people who may somehow have been able to play off an inside connection, particularly people who previously worked in the Department.

And I include Mr. Strauss in that list.

I'm going to raise three more questions, then I'm going to yield to my colleagues.

Mr. Michael Karem, a former deputy assistant secretary for the Multifamily-Housing Area, during the Reagan Administration in the Department of Housing and Urban Development, how much did Mr. Karem receive?

Mr. ADAMS. $420,000 in connection with three projects.

The CHAIRMAN. Where were those three projects?

Mr. ADAMS. Illinois and Michigan.

The CHAIRMAN. Mr. Louis Nunn, a former Governor of Kentucky, he apparently also received a large sum of money through this program.

How much was that?

Mr. ADAMS. $375,000 in connection with a project located in Florida.

The CHAIRMAN. Finally, John Mitchell, former Attorney General of the United States, does he not have a relationship with Ms. Dean?

Mr. ADAMS. We are informed that he was her stepfather.

The CHAIRMAN. John Mitchell, of course, was the former Attorney General of the United States. What did he receive?

Mr. ADAMS. He received a payment of $75,000 from Mr. Nunn.

The CHAIRMAN. I'm going to come back to this but, at this point, I want to yield to my colleagues. I yield first to Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman. Let me preface my questions by saying that I'm troubled in particular about two aspects of this.

One, I am troubled by the fact that a good many of those who profitted inordinately after they left the agency are the same folks who, when they were with the agency, sought to undermine this program, to minimize its availability.

And once they left Government service, then sought to profit by the same program, which they had in effect over many years indicated to the Congress that did not require the level of funding and did not, at least in their official capacity, enjoy much priority.

Second, I'm troubled by what appears to be the inordinate fees that were made by the persons that you've just identified.

Having said that, there are many people in this country who would say, "Well, look, there are tens of thousands of people in Washington, D.C. who make their living by reason of contacts which they develop when they were part of the Government in some particular program or agency."

Tell us, Mr. Adams, if you will, how do we define and make a distinction between this kind of conduct which I'm troubled by, and I want to make that very clear, and others who have left Government service and who, in effect, have participated and enjoyed rather substantial financial rewards as a result of the contacts which they've developed in public service?

Mr. ADAMS. That's a tough issue, Senator Bryan. Let me attempt to give you some insight into it.

My feeling is that we should try to have programs that are as simple and straightforward as possible so as to require as little effort as possible in the process.

Senator BRYAN. I don't disagree with that.

Mr. ADAMS. And, therefore, would minimize the need for consultants.

Also, if there is to be a consultation fee, that it be proportional to the services rendered.

Senator BRYAN. I don't disagree with that philosophically, but I think we need to probe just a little bit more deeply, Mr. Adams.

I think that some of us would be a little bit reluctant to get involved in the Congress establishing a fee schedule.

Again, in no way does that question imply or suggest that I think that what you uncovered is reasonable based upon what appears to be the amount of work done.

But, yet, people do make a living as consultants, as people who, in effect, hold themselves out as knowing people in this City by reason of their prior associations.

Help me, if you will, and give us guidance as members of this committee because we want to prevent the recurrence of this type of abuse.

But, what kind of guidelines? How do we close those loopholes? What do we need to do to see that this is not visited upon us again?

Mr. ADAMS. Well, we recognize and share your concerns also. At the time I sent the report forward to the Secretary, I recommended the Department consider at least the model of the Procurement Integrity Act, which was passed for the Department of Defense and other procurement agencies which concerns conflicts of interest. Recognizing that there are some concerns with that piece of legislation.

But, at least it could be a model they could work against in trying to address that issue. The act contains provisions for sanctions as well as public disclosure on the role of the consultant. I think, tends to regulate the process somewhat also.

Senator BRYAN. Would I be correct in making the assumption that that would address part of the problem? That is, those individuals who have been specifically employed in the agency who left?

Mr. ADAMS. That's correct, sir.

Senator BRYAN. But there are others, if I am correct. I'm informed Secretary Watt, for example, within another Department; Senator Brooke, I don't know whether he had any prior association or contact as an employee of the agency. I would presume the conflict of interest criteria that you are suggesting would not apply to those two individuals in the context of what they did with the mod rehab program?

Mr. ADAMS. We would also be an advocate of public disclosure. The openness of it I think tends to also help regulate the process.

Senator BRYAN. I don't disagree with you there either.

Any other areas that you can suggest? And, again, I don't want to appear as an apologist for what these people did; yet, people are going to make money as a result of contacts that they've developed. We don't want them to abuse this, the point that you're making and which I would agree with.

I'm trying to get some help in terms of what type of legislative response should this committee consider? Or can we do it by regulations? And Secretary Kemp has indicated his sensitivity.

I would commend him by in effect bringing a halt to this practice and trying to reexamine what's occurred and, hopefully, develop some internal guidelines.

So, help us out. What do we need to do legislatively? What do we need to do by regulation?

Mr. ADAMS. I can only add one additional thing. On behalf of Secretary Kemp, I know he's asked our General Counsel to do an extensive research on that entire issue, and that about exhausts my options for you on this point, sir.

Senator BRYAN. Thank you very much.

The CHAIRMAN. Thank you very much, Senator Bryan.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Several of us thought for a long time that the former Secretary of HUD, some people had said he was invisible. Maybe he was to us. Maybe he was to the public. But, obviously, he was not invisible to this list of people that were doing the backroom dealing here. He was busy at work; he was just invisible to us.

But he was very visible to these people that you've just related that were making these fees for telephone calls or for writing a letter. Most of them, I bet, didn't write letters. They made calls.

When you start talking about public disclosure, did you dig this up? Did you find this out by just getting into part of an audit? You haven't done a nationwide audit, a local audit, like to regional offices and so forth?

Mr. ADAMS. Those are just samplings.

Senator SHELBY. These are just samplings?

Mr. ADAMS. Yes, sir.

Senator SHELBY. If this is just a sample of what's going on, it could just be the beginning of what you could uncover?

Mr. ADAMS. Possibly, sir, yes.

Senator SHELBY. When we're talking about people like former Senator Brooke, former Governor Louie Nunn, former Secretary James Watt and Richard Shelby—not this Richard Shelby—and others, did they ever tell you in any way how much time they spent doing this consulting work?

Any of you?

Mr. ADAMS. Mr. Neri, could you respond to that?

Mr. NERI. No, sir. They would describe doing things like preparing applications, technical advice, arranging meetings—not necessarily putting in time.

Senator **Shelby**. By arranging meetings, this was with people that they were connected with either politically or personally, at HUD?

Mr. **Neri**. That was the impression on the part of the people that they were reporting back to. The developers and so forth.

Senator **Shelby**. This is basically influence peddling on one of the highest degrees, isn't it?

Mr. **Neri**. It could lead you to that conclusion, yes, sir.

Senator **Shelby**. Has the Justice Department been consulting with you regularly on this?

Mr. **Adams**. Yes, sir. We involved them very early in the process, which is normal; if there's any potential for criminal violations, we seek early consultation.

Senator **Shelby**. The FBI had been involved?

INVESTIGATION TO CONTINUE

Mr. **Adams**. The Public Integrity Section of the Department of Justice has been informed in all instances, and we continue to have dialogue with them on certain matters. The investigation is continuing to go forward.

Senator **Shelby**. Has the Attorney General himself been involved in this?

Mr. **Adams**. Not to my knowledge, sir.

Senator **Shelby**. Did you total up these fees? You say they're just a sample of some consulting fees. Did you total those up, basically, the ones you're talking about from Phillip Abrams on down on this page?

Can you tell just roughly? You don't have to calculate it. It's several million dollars, isn't it?

Mr. **Adams**. Staff tells me it's about $4 million.

Senator **Shelby**. And as you said a minute ago, it could just be the beginning or a sample of what's gone on?

Mr. **Adams**. Yes, sir.

Senator **Shelby**. Do you know if this has been going on before? Is this a way of doing business with HUD? Has it been during the Reagan Administration and prior to that?

Mr. **Adams**. At different times, we've heard rumors or allegations concerning this. We attempted once before, 3 years ago, to do some work in the consulting area. It was rather unsuccessful. It was only when we started looking at individual developer records that we discovered these things.

As I indicated earlier, there's no systematic way of identifying those without going directly to the developers and inquiring of them.

Senator **Shelby**. How many people in this group here used to work at HUD in high positions?

Mr. **Adams**. I believe there are 11 former HUD officials involved.

Senator **Shelby**. In other words, it's just a revolving door there, so to speak?

Mr. **Adams**. Yes, sir.

Senator **Shelby**. Were they in positions in HUD working with people that later made these same type of decisions to give these awards? In other words, do the allocations?

Mr. ADAMS. Yes, sir, some were.

Senator SHELBY. Some of them were working in the very sections of the very offices that later made the awards to them privately?

Mr. ADAMS. That's correct.

Senator SHELBY. What was the timeframe from the time some of them, just a couple of them, left? Let's say, Phillip Abrams. When was he the Under Secretary, just roughly?

Mr. ADAMS. Mr. Abrams came with the Department in March 1981 and left in November 1984 to return to private industry.

Senator SHELBY. And then his primary work as far as you know was consulting and trying to get things—allocations out of the area?

Mr. ADAMS. Mr. Abrams was not a consultant. He was a developer.

Senator SHELBY. What did my namesake, Richard Shelby, what did he actually do at HUD, if anything? Did he ever work at HUD?

Mr. ADAMS. No, Mr. Shelby was not a HUD employee.

Senator SHELBY. Was he just a political broker, so to speak?

Mr. ADAMS. He had a brief tenure, we're told, in the White House personnel office.

Senator SHELBY. Is he currently working for the Republican Senatorial Committee, a director or something of that nature?

Mr. NERI. No, sir, I don't know.

Senator SHELBY. You mentioned the word "material" early when you were interviewing people. Am I correct on that? In other words, if a matter was material, like if someone told you something that was not true and then later changed their story, wouldn't that border on criminal violations possibly?

Mr. ADAMS. It could be a false statement.

Senator SHELBY. To something that's material, wouldn't this money and your investigation of it be a very substantive issue to pursue? And the things you were getting from it could be material to your investigation?

Mr. ADAMS. Yes, sir.

Senator SHELBY. Mr. Chairman, I know my time is expired. I'll wait until the next round.

The CHAIRMAN. Thank you, Senator Shelby.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Adams, I'm interested in the economics of this transaction. As I understand what we have here as the law envisioned was that local public housing authorities would make applications to HUD for funding for less than a major renovation, but more than typical maintenance to remodel these residences. And also for section 8 certificates to cover subsidized rental payments for those units after they had been rehabilitated.

Is that essentially the way the program was supposed to run?

Mr. ADAMS. That's correct, sir.

Senator GRAHAM. And it's supposed to be on a competitive basis, both at the HUD office either at the region or in Washington, in terms of who received—which PHA's received the funds.

Then, at the PHA level, which developer was actually designated to do the work and get the section 8 certificates.

Is that right?

Mr. **Adams**. That's correct.

Senator **Graham**. What interests me from the examples that you gave, it sounds as if there was a pattern that more or less $1,000 a unit was being paid to the lobbyist or the intervenors in order to get a preferred developer designated to get the money for the rehabilitation and the section 8 certificate.

Is that more or less in line with what you found?

Mr. **Adams**. That was true in some instances. Not all instances. There were some transactions that did not involve consultants.

AVERAGE CONSULTATION FEE

Senator **Graham**. In those where there were these fees paid, what would be the average fee per unit?

Mr. **Adams**. They ranged from $500 to $1,500.

Senator **Graham**. Taking that range, how did the economics of this transaction in terms of the developer work out to be able to absorb that much of a nonproductive overhead fee?

Mr. **Adams**. We have some information to the effect that in some of those transactions, the payment of the consulting fee probably came from the proceeds of the syndications and others that may have come from the developer.

Senator **Graham**. It is my understanding that the manner in which the section 8 certificates were issued was that there was a marketplace rental, let's say, a unit after rehabilitation had a marketplace rental of $300 a month.

And if the resident in that could only afford to pay a $100 a month, then the section 8 certificate would be for $200 a month?

Mr. **Adams**. That's correct. The tenant could not be required to pay more than 30 percent of their income.

Senator **Graham**. I come back to the question:

Assuming that the market rate rental was $300—in my hypothetical—and the tenant is paying 30 percent, that he or she can afford to pay, where is there money in that process to pay these kinds of exhorbitant fees?

Mr. **Adams**. In some situations——

Senator **Graham**. To put it another way, if all the developer is going to get out of it is marketplace rentals, presumably there are a lot of other investments in real estate in the community that would also produce marketplace rentals. Why absorb a $1,000 a unit lobbyist fee in order to get into this particular program?

Mr. **Adams**. In some of the situations, the consultants were also involved in getting increases in the fair market rents of a 100 percent—120 to 144 percent of fair market rents.

Senator **Graham**. So you're saying that the Federal Government through bloated rental rates was subsidizing these lobbyist fees?

Mr. **Adams**. That was the increase in the rents which made monies available to pay those fees, yes, sir.

Senator **Graham**. Could you give some specific examples of those over-market rate rental fees?

Mr. **Adams**. Mr. Greer, can you respond to that question? Mr. Greer on our staff supervised the audit.

Mr. **Greer**. I'll attempt to do that.

The first misconception I want to try to allay is that fair market rents are established by HUD. The mod rehab rents go up to 120 percent of the existing fair market rent. Those rents don't necessarily mean that's what's being paid in the marketplace.

In most of our audits, we found that the rents that were in fact being paid were very, very close to the maximum FMR's that were available in those localities. And the things that we think induce an owner to get involved in a section 8 program are guaranteed income stream—that is, for 15 years. Also there were at the time, and even more lucrative now the tax benefits associated with low income housing. And I think it's a combination of those two things that induce owners to get involved in the section 8 program.

Senator **Graham**. Are you suggesting that even after paying these large lobbyist fees that the economics of section 8 with the guaranteed income stream and the tax benefits results in an economic inducement to developers, that is, developers who are able to make a higher return on their investment from this program than alternative real estate opportunities?

Mr. **Greer**. We didn't compare the return on equity in this program to others at this point in time. But the program regulations have built into them at least a 10 percent return on equity. That certainly is sufficient for a developer to get involved.

A 10 percent return on equity is built into the computation of the rents.

Senator **Graham**. Mr. Chairman, my time is up. I would like to come back to this issue.

The **Chairman**. Very good. We do have other witnesses who are scheduled to appear this morning, some of whom were the consultants we have already mentioned. So we'll want to hear from them as well.

I think what we are hearing though makes it clear that there was a major problem in this area. I think it's a scandal and there's really no other way to describe it. That isn't to say that everybody whose name arises in connection with this necessarily did anything wrong.

But I think the pervasive pattern of what you have already discovered is a pattern that is just improper and wrong. And whether or not it crosses the line into criminal activity or not, I think we're going to need a very searching examination to determine that. And I hope that will be pursued thoroughly and aggressively by everybody who has responsibility in that area.

But, at the least, what you see happening is the skimming off of very large sums of money into private hands. And I think the line of questioning that Senator Graham has just been pursuing is very important to lay out the economic construction of how this program was intended to work, and then, how it was changed in order to create these windfall gains.

In effect, what was happening here was not only were individuals becoming wealthy by having the inside connections, or so it appears, but by taking the money out that way, it takes it away from its intended purpose, which was to try to make more low-income housing available to people in this country.

We've got an enormous housing shortage. So every dollar that was available to try to help people get into decent housing ended up getting diverted and skimmed off with excessive fees and profits by individuals who were milking the system. You've got another class of victims here.

TAXPAYERS BEING VICTIMIZED

You've got the taxpayers who have been victimized, but you've also got the people who are out there standing in line hoping to get into a low housing unit and finding that they get priced up partly because of the mechanism by which the dollars were produced in this money system.

So I think it's very important to lay out how this program changed to create these windfall gains that then were disbursed in the pattern we are beginning to see.

I want to find out about every project that was done in the country. I want every State looked at.

Now, do you have the authority to go ahead and get that work done? Do you have the people that you need to do it? I would like every State housing authority to have to provide the same data that you have gotten in the cases that you've covered here.

In other words, I don't want just the tip of the iceberg. I want the rest of the iceberg.

Do you have the authority to do that at the request of this Committee?

Mr. ADAMS. I have the authority, Mr. Chairman. I'm not sure I have the resources to undertake that task.

The CHAIRMAN. You tell us what you need because we want to fix this thing so that the money doesn't leak out this way in the future.

I want you to understand the request I'm making. How many States or local public housing authorities have you posed inquiries to assemble the data that you now have?

Mr. GREER. About 200, sir.

The CHAIRMAN. What would be the total that are out there? The rest, that you have not yet queried?

Mr. GREER. There's only about 50 or 60 that we haven't got good detailed information on.

The CHAIRMAN. Have you asked for that?

Mr. GREER. No.

The CHAIRMAN. I'd like a commitment now that you will get it. Can you give me that commitment today?

Mr. ADAMS. Yes, sir.

The CHAIRMAN. Very good. I'd like you to get started on it. I'm sure that if you need additional help, you will tell the Secretary. He and I have spoken about this. I know he's as troubled about it as anybody. He's acted quickly.

I'm speaking of Secretary Kemp. Whatever you need in the way of resources, you ought to have, because I want to know what happened here. And the public has a right to know.

I want to ask you just two other things, and then maybe we can do one more brief round of questions and get on to our other witnesses.

As this program changed shape, starting in about 1983, it went from a program that was aimed at a small, targeted activity into a major rehab program for large, multi-family projects.

I'd like you to provide for the record what the average rehabilitation cost per unit was in the projects that were audited, what was the range of the rehabilitation cost per unit, what was the average project size of the project audited?

And what is your assessment of how the program changed?

I want you to give us that for the record.

[Information follows:]

The Moderate Rehabilitation Program was originally designed and executed to bridge the gap between Section 8 Existing and Substantial Rehabilitation Programs, and was targeted to small developments of 20 to 30 units with rehabilitation costs being projected at the $3,000 to $8,000 range. Our audit revealed that during the period 1984–1988, the Program evolved into one of the larger developments, with some being over 300 units and per unit rehabilitation costs for over 4,800 units we examined averaging $26,352. The per unit costs ranged from $4,594 to $80,273 and the average project size audited had 118 units.

The CHAIRMAN. One area I want you to respond to now, Mr. Adams, is the area of development profits. That's an area that has not received much attention to date.

I want you to provide the Committee with perhaps two or three brief accounts which you believe the developer either made or anticipated making from a project in which mod rehab subsidies were received.

I'm particularly interested to have you give those facts and any biographical information on the developers that you have with both the Sierra Pointe project in Clark County, Nevada, and also the Pebble Creek project in Arlington, Texas.

So if you can run us through those two.

Mr. ADAMS. Yes, sir, let me just qualify that a bit. We're still doing some work in connection with those. So the information I have is somewhat preliminary and subject to some change.

I'll ask Mr. Greer to respond because he again has been supervising that activity.

The CHAIRMAN. Give us what you have.

Mr. GREER. Sierra Pointe is a project that was developed by the so-called Winn-Abrams group out in Clark County, Nevada.

The CHAIRMAN. Let me stop you there.

Who are the Winn and the Abrams that you're speaking of here?

Mr. GREER. Philip Winn, former assistant Secretary at HUD during the first, early years of the Reagan Administration, 1980–1981, in that area.

The CHAIRMAN. And the Abrams?

Mr. GREER. Phillip Abrams came to HUD with Mr. Winn and had progressively higher positions and left the Department in 1984 as the Under-Secretary.

The CHAIRMAN. So they formed a development partnership. How did they do in the Sierra Pointe project?

Mr. GREER. Sierra Pointe is a 160-unit project. The key thing that I think you're talking about here is that the development partnership through the use of low-income housing tax credits was able to walk away from the closing table, let's say, with between $600,000 and $1 million.

We are unsure about the $400,000 difference because we haven't yet tracked the source and the disposition of about $1.5 million.

The CHAIRMAN. To nail this down, what you're saying is the way this program was structured is that on the front end, the day this deal was signed, the developers walked away in your estimate with a profit of that amount?

In other words, there was that much front end profit in this thing on the very first day.

Is that correct?

Mr. GREER. Yes. And that comes basically from the proceeds of low-income housing tax credits wherein a syndicator will buy the credits for 50 cents on the dollar.

The 50 cents in this case is the numbers that I just mentioned here.

The CHAIRMAN. So there was another area of what I think might fairly be called windfall gains from this kind of activity.

And if you were wired into it and you were the right developer in the right spot, you could enter into these deals and walk away with these kinds of up front profits.

Mr. GREER. Yes, sir. In our audit report, we recommended that the Department establish a policy to recognize the benefits of low-income housing tax credits when they're computing rent.

The CHAIRMAN. Is Mr. Winn the fellow appointed as our Ambassador to Switzerland, the same fellow?

Mr. GREER. Yes, sir.

The CHAIRMAN. Let me just go now to the Pebble Creek project in Texas.

Mr. GREER. Pebble Creek is about a 300-unit project. It's in Arlington, a suburb of Dallas. The developers in this case are Gerald Carmen and Joshua Muss. Gerald Carmen, the former GSA Administrator, who most recently was at FADA. I'm not sure what he's doing now.

Joshua Muss is a well-known developer.

The CHAIRMAN. How much did they walk away with on the front end of the deal in Pebble Creek, in Arlington, Texas?

Mr. GREER. As Paul just mentioned, we are currently auditing that project. We obtained a series of documents that show cash flow and tax benefits from the mortgagor's books and records. Every indication is like the one I just described.

In this case, we had two partners who shared tax credits of about $2.3 million, or $1.1 million a piece.

The CHAIRMAN. That's front end profit the day the papers were signed.

Mr. GREER. The day that the syndicator pays the partners for their tax credits, that often is done over a period of years. It doesn't necessarily happen the day of closing.

The CHAIRMAN. In the interest of time, we've got a number of important witnesses to get to so I would like this round to be the last round with these witnesses. We can have them back at a later time if we need them.

Senator Garn.

Senator GARN. Again, I had the opportunity to have Mr. Adams before the other committee yesterday, so I have nothing.

The CHAIRMAN. Thank you, Senator Garn.

Senator Bryan.

Senator **Bryan**. Thank you, Mr. Chairman.

TAX CREDITS

The operating of economic forces that made this possible, Mr. Greer, if I understand your testimony, would be the tax credits that are available apparently under the Internal Revenue Code.

Am I correct? That's one aspect of it?

Mr. **Greer**. That's one aspect, sir.

Senator **Bryan**. The other, I gather, would be the manner in which these market rental rates are established. Wouldn't that be a driving force as well?

In other words, the higher you get those up, the larger the amount of subsidy?

Mr. **Greer**. That's correct. The tax credit itself is based on the rehabilitation costs and the higher the cost, obviously, the higher the credits, yes, sir.

Senator **Bryan**. Are there any other factors which contribute to the cash flow that can be generated from these kind of projects other than the tax credit and the market rate?

Mr. **Greer**. As far as cash flow, it's important to recognize that we did not look at the operations of these projects. We were only involved in the development end of it.

So we haven't really any firm numbers on how the estimated expenses, in fact, are coming out. We do know exactly how much the income is because the rents are established through this computation.

Senator **Bryan**. But, pretty clearly, the Congress ought to be taking a look at the tax credit, at least as it relates to these kinds of projects and the manner in which the market rental rate is established, should we not?

Mr. **Greer**. We just got a copy a couple of days ago, to comment on S. 920, which is revising the tax credit. We believe there are some provisions in there that may help the situation.

Senator **Bryan**. Would you spend a couple of minutes with us and tell us again who are the participating parties in developing this market?

I understand that those who are involved in the co-insurance function also, in fact, have played a role in establishing what the market rate would be. Or at least the level of reimbursement that's available. And that there may have been an inherent conflict of interest in this as well because the larger the number, the greater their fee would be for providing that kind of assistance.

Mr. **Greer**. That's an excellent point. Starting in mid to late 1986 on through 1987 and 1988, we noted that about half of all mod rehab projects, or all units, I should say, were financed through HUD's co-insurance program, either the 221(d)(4), or 223(f) program.

Whereas, in the past, HUD would have had a lot of controls over the establishment of the rental rates, when co-insurance was introduced into the equation, HUD delegated all of its responsibilities to these co-insurers in return for a sharing of the risk, so to speak.

In promulgating those rules and regulations there was a lot of confusion about who had what role. Basically, we were told time and again by developers and PHA's and by HUD employees that they simply abdicated their responsibilities to the co-insurer. Therefore, the co-insurer was doing the appraisals necessary to establish values of property and also doing all of the work to establish the rental fees.

Senator BRYAN. And the compensation for the co-insurer? The money that the co-insurer paid would be based at least in part upon the level that was fixed?

Mr. GREER. They get fees based on the amount of the mortgage. They also get fees for servicing the mortgage. All co-insured loans are also backed by Ginnie Mae securities and there's some money to be made in that area as well.

Senator BRYAN. Mr. Greer, prospectively, how do we address that situation? How do we prevent that from recurring?

Mr. GREER. In response to our audit, Secretary Kemp has taken many, many steps. And one of those that he promised to do and just recently issued on May 5th, I believe, letters to both the co-insuring community and to HUD officials spelling out new procedures for establishing the rents in co-insured Mod Rehab projects, which we feel will greatly strengthen the cost controls for the Department.

Senator BRYAN. Mr. Greer, are you satisfied as one who has looked at this very closely from an auditing perspective that the new controls that the Secretary is recommending or is implementing, are sufficient to get a handle on it?

Because as I understand your testimony in response to an earlier question, in effect, HUD previously had delegated this authority to the co-insurance community and clearly didn't play much of an oversight role.

Mr. GREER. HUD will now have a direct role in the establishment of the rental rates and in establishing the value of the properties. The one area that we still have some concern on is the recognition of tax credits in the computation of rental rates.

Senator BRYAN. My time is nearly running out. Just a last question to shift the focus a little bit.

As I understand the way these things were packaged, frequently, those that had the inside track, the inside information, kind of go and say, Look, I think we can get some units rehabbed for you here. Are you interested?

And the local public housing authority would say: Yes, if you think you can help us out, sure.

Is that a correct perception? In general, my question would be:

To what extent, if any, did you find any impropriety or questionable activity by those that were involved with the local public housing authorities themselves?

Or is this simply—I use the word "simply", but by way of contrast, is it a problem that was basically a developer- coinsurer-consultant type of a situation?

Mr. GREER. I'm not sure how to respond to that except that time and again we were told, and I believe the audit and the investigation will show, that their problem was not the impropriety at the public housing authority level. The projects were selected and allocated by HUD headquarters and oftentimes the PHA's were the last to know.

Senator **Bryan**. There's no suggestion that we would need to at least consider changes, at least in the public housing authorities' involvement?

Mr. **Greer**. No. I think the rules and regulations at the local level were probably sufficient if they were carried out.

Senator **Bryan**. Thank you, Mr. Chairman. My time is expired.

The **Chairman**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman. I've got several questions. I'll try to be as terse, and I'll ask if you can do likewise.

COINSURANCE

The role of the co-insurer, did I understand you to indicate that the co-insurer was effectively determining what the rental rates for section 8 units would be?

Mr. **Adams**. That's correct, sir.

Senator **Graham**. Does the co-insurer have a conflict of interest in terms of having some interest in high rates, understanding that degree of excess is going to be picked up by the Government, with the tenant being limited to 30 percent of income?

Mr. **Adams**. Yes, sir, I would say so because they kind of gold-plated the property because it created a better mortgage security.

Senator **Graham**. By what process did HUD agree to turn that authority over to the co-insurer?

Mr. **Adams**. There were two programs that had come up concurrently, or crossed each other. The conflict arose between the regulations of the two. That is what has now been resolved by the new process that's created.

Senator **Graham**. I mean, was there a public discussion within HUD or in the general public as to the adoption of a policy which turned over to the co-insurer the responsibility for establishing rental rates?

Mr. **Adams**. I think it's just one of those things that everyone missed. It was just an opportunity that someone took advantage of later.

Senator **Graham**. I'd like to come back to that question as my last question.

The original program, you contemplated a competitive process at the HUD level of which PHA's would receive funds for this rehabilitation of the section 8 program.

Is that correct?

Senator **Graham**. What happened to the competitive program which appears to have been substituted by a pernicious entrepreneurial program?

Mr. **Adams**. You said at the HUD headquarters level? Is that correct?

Senator **Graham**. Yes.

Mr. **Adams**. In that process, up until 1984, there was a fair share allocation process which allocated by fair share formulas down to the regional offices and the regions did the competition. In 1984, Congress waived 213(d), which is the fair share process. And the Department proceeded with a contracting universe of units available and in the absence of the fair share, it became more of a discretionary program.

Senator **Graham**. Still, whether Congress was wise or not wise in 1984 by moving the decision from the regions up to central HUD, was it HUD's interpretation that Congress continued to advocate the competitive process and make it strictly discretionary as to who got the grants?

Mr. **Greer**. If I might, Senator Graham, there are regulations that require competition under the headquarters reserve. I can't recall the exact number of the regulation. It was 719 or 791, somewhere in there, that has a given set of criteria when an application demand exceeds supply.

There's a set of criteria that HUD headquarters is supposed to follow. And as our audit report points out, in no case from 1984 to May of 1988 was there a rating and ranking of applications performed by HUD headquarters. They simply responded to letter requests that had been sent in by local housing authorities.

Senator **Graham**. Was there any public statement that HUD was changing from a competitive to a discretionary process, as you have outlined?

Mr. **Greer**. If you mean by public notice in the Federal Register, no, sir, there was not. There were memoranda issued at various times in some of these years describing to the local HUD officials how funding allocations were going to be made during those years.

There's nothing in the Federal Register, if that's what you meant by public notice.

Senator **Graham**. In reference to the tax credits, the original purpose of the tax credits was to enable developers to raise private capital at favorable rates in order to reduce the rents for low-income housing.

What you've described doesn't sound as if the tax credits were used for their intended purpose. Is that accurate?

Mr. **Adams**. We don't believe that they were receiving appropriate consideration in the computation of rents.

Senator **Graham**. Is there any evidence that the availability of these credits resulted in any lowering of the rental structure?

Mr. **Adams**. I don't believe our studies were extensive enough to draw a conclusion in that regard, Mr. Graham. I think what we found earlier in the process, the supply was rather great and the demand was very low. So there was not a lot of caution used in allocating those tax credits.

Senator **Graham**. My last question, as the yellow light comes on, is: How in the world did we get into this process and so many years passed before it was brought to our attention? What is your—what does the Inspector General's Office draw from this process in terms of its own standards and procedures?

Do you have some statistical measures that you monitor that would be early indicators of problems?

Do you monitor changes in institutional behavior such as moving from a competitive to a discretionary system that might be signals of behavior to your knowledge?

Were any of these matters reported to a Federal enforcement agency such as the FBI? And if so, did they come to your attention through such enforcement agencies?

What lessons from this experience in terms of how you, the watch dog, can be more vigilant and watch our house at the front door, not at the basement, as we are observing a fire?

Mr. ADAMS. A couple of thoughts come to mind. We go through a planning process to identify work for the coming year, for our audit function.

Some of the planning criteria we use are program changes, new legislation, new regulations and so forth. This program came up in our planning process.

We began to do the work early in 1988. And what we're doing most often, Senator Graham, is auditing against past performance. And as you might recall, most of the changes occurred in 1984. They had a certain bit of time in the pipeline. We think our response is timely in that regard. We wish it could be a lot more timely. But audit and investigative work is retrospective.

You're looking back on what has happened. We have no knowledge of any disclosure to any other auditor, or any other complaints.

As I said, we have received at different times complaints that consultants played some role or that someone's not getting their fair share. We always follow up on those. But, quite often, we find that the persons supposedly having the knowledge, only had hearsay information.

We ran into quite a bit of that during the course of this review. In fact, we had some leads from a couple of house staffers on the subcommittee side. We followed up on those leads with people they identified and they said:

No, we've heard this but we have no personal knowledge.

Those are the kinds of things that confront us as we try to do our jobs. At the same time, we have to make an informed judgment about rumors we hear and the pursuit of those. We have to make decisions on what to pursue and what not to pursue.

I know it's not probably a very satisfying answer, but that's the way it works.

Senator GRAHAM. Do you have a recommendation as to how your operation can work more effectively? That is, through additional resources or institutional changes? I'd always appreciate it.

Mr. ADAMS. We think one of the primary changes is monitoring by the people that are administering the programs themselves, what's happening at the local level. Monitoring is one of the things that suffers at a time of budgetary constraints.

The CHAIRMAN. Thank you, Senator Graham.

In the interest of time, we all have other questions we would like to raise, and we may call you back at a later point. But I think we've covered very important ground here today. We have a commitment now and established that you'll continue to put the rest of this factual case together and go out and examine all the other activities.

I am very much interested in following the chain of events step by step. I not only want to know what happened in all areas of the country, but I also want to know what other sort of bonanza type situations we have created at different levels, whether for developers, consultants, or other people in this chain of activity who ended up making very large sums of money.

So, as you go down through your work, if you see offshoots where appreciable sums of money were drained off in some direction other than to actually produce the end product that the program was designed for, I want you to bring that to our attention.

I appreciate the work you're doing, I might say. Employees in the Federal Government oftentimes take criticism and are of the subject of cartoons and all kinds of things as to whether or not their work is being done.

I appreciate your commitment to public service. I appreciate the fact that you're all working in the public service for less money than you could all be earning outside in the private sector.

Your work is important and I want you to say as well on behalf of this Committee to your subordinates that we appreciate the work they are doing under your command. This is a very important assignment and you've made very good progress with it. I appreciate that. The Committee appreciates it. And we want to have you continue on and put this whole story together.

Mr. Adams. Thank you, Mr. Chairman.

The Chairman. Thank you, Mr. Adams.

We'll now move to our next witness. Let me call to the table a former colleague and member of this committee, a distingished member for many years, an attorney here in Washington area now, former Senator Ed Brooke.

Senator Brooke, let me suggest here, after we hear from you and have a chance to ask questions, we have four other witnesses we are going to hear from this morning.

I want them to understand that we will take the time that is required to accord everybody the time that's needed. But, let me say you have many friends of longstanding on this committee on both sides of the aisle. And the Chairman considers himself very much in that group.

So we are pleased to have you this morning.

Senator Garn. Would the Chairman yield for just a moment?

The Chairman. I'm pleased to.

Senator Garn. It's nice to welcome you back, Ed. Ed was Ranking Minority Member of this committee when I was a very junior member and sat there.

I do welcome you back before the Committee. I apologize. I have to leave. Having been a Senator, you know, when the White House calls and says there's a meeting, you just go—whatever else is going on.

I do have a meeting at the White House in a few minutes, and I apologize for having to leave.

Mr. Brooke. I certainly understand. Thank you very much.

The Chairman. Senator Brooke, why don't you make whatever opening comments you'd care to make?

STATEMENT OF FORMER SENATOR EDWARD W. BROOKE, WARRENTON, VA

Mr. Brooke. Thank you, Mr. Chairman. I thank you and the committee for the opportunity to appear before you this morning. As you, Mr. Chairman and members of the committee are painfully aware, funding for low-income housing has been and continues to be woefully inadequate.

The programs which we created in the 1970's were designed to encourage the creation of a private housing industry to provide affordable housing for low-income families.

As a result, a large industry grew up to meet this challenge. When funding was further reduced in the 1980's, developers and local housing agencies serving the ever-increasing need for low-income housing naturally sought assistance in their efforts to obtain funding for projects in their communities.

As the total Federal appropriations for these programs, such as section 8 mod rehab, were reduced, the funds began to be allocated on a discretionary basis rather than on the basis of formula.

This decision was made by the Congress because there were insufficient dollars to provide each community with its fair share of funds.

As with any discretionary program where there are many worthy applicants and an under-funded program, it was understandable that those who wanted to participate would seek advocates for their projects.

I have been an advocate for such projects. Two, namely, Cobbet School and Crystal Park, were addressed in the Inspector General's report of April 17, 1989.

There is no question as far as I know about the fact that both of those projects were targeted for cities with severe shortages of low-income housing, and that lower income families are being well-served by those two section 8 mod rehab projects.

INAPPROPRIATE INFLUENCE ACCUSATION

But what has concerned me, Mr. Chairman and members of the committee, is the impression created and the implication that I used inappropriate influence to obtain funding for those projects and that I did not perform sufficient services for my fees.

On the contrary, I spent many hours over a period of several years working on both of those projects. And any impression or implication of inappropriate influence or insufficient services for my fees is patently false and misleading.

I had no special pipeline into HUD. I dealt with a number of HUD officials over the years, presenting the merits of the project on which I was working. Not only did I advise clients on HUD policies and procedures, but on State and local programs, tax and housing legislative changes affecting low-income housing development and financing.

Let me briefly review the two Massachusetts projects in question. The Cobbet School was an old brick schoolhouse located in Lynn, one of the oldest cities in the Commonwealth of Massachusetts.

The city of Lynn had closed the Cobbet School because of declining pupil enrollments. In keeping with the city's commitment to revitalization, the city put the building up for sale and a local developer, Mr. George Clayman, developed a plan to provide low-income housing for the community at the Cobbet School site.

I first met Mr. Clayman when he came to see me in my Washington office on August 11, 1982. We first discussed the Cobbet School project in September 1982, at which time, I asked him if there was a demonstrable need for low-income housing for that particular site.

He told me there was. But he also told me of his reluctance to exercise an option to purchase the building if financing would not be available for the project.

I explained to him that funding for such a project could not be guaranteed, a fact to which he and his partner should give serious consideration prior to exercising their option.

I further advised him that he should work with and secure the support of the Lynn city officials and the Massachusetts Congressional Delegation in preparing a proposal for funding.

He did. And we had many conversations over the next several months discussing how he should proceed at each step along the way and his progress to date.

Subsequently, the project was complicated by the need to reconfigure into larger family units in order to comply with local needs and the Massachusetts Housing Finance Agency [MHFA] requirements.

We worked with Mr. Clayman and the MHFA in meeting those requirements. In 1985, Mr. Clayman requested my assistance in securing a waiver for an increase in the fair market rents of the Cobbet School project.

We researched the appropriate rules and regulations, held some meetings and conferences in finalizing the request for a waiver, but HUD ultimately denied the request.

Before the project was finally funded in 1987, after a 4-year effort, we also became involved in providing guidance and recommendations with respect to the significant tax changes embodied in the Tax Reform Act of 1986, changes which severely impacted the ability to secure necessary equity capital for the project.

In summary, this was a very complex project which required significant time, energy and effort.

The second project, Crystal Park, is located in Worcester, the second largest city in Massachusetts, and another city with a large low-income population.

Crystal Park was proposed and developed by State Street Development Corporation, a company whose partner, Mr. John Gallagher, had retained my services as a Washington consultant in 1981.

At that time, we entered into a contract whereby I would keep State Street Development Corporation informed of current developments, legislative and regulatory, affecting the real estate industry and assist them on specific projects which they would bring to my attention.

In the spring of 1986, Mr. Gallagher called me to tell me of a project, Crystal Park, which had been pending at the Massachusetts Housing Finance Agency awaiting financing for some time, and a project which could help alleviate the severe low-income housing shortage in Worcester.

It involved renovation of an old mill in that industrial city. I suggested that he contact the Worcester Housing Authority and that I would work with him in reviewing and amending the application as necessary.

I worked with Mr. Gallagher and the Department to help to secure funding for the project using recapture authority under the section 8 Mod Rehab Program.

Subsequently, Mr. Gallagher requested my assistance in preparing a request for waiver of the current fair market rent regulations, primarily due to the high cost of development and renovating the old mill and the higher than average rent in that particular part of the city.

I assisted State Street Development in this effort. However, the request was denied by the HUD regional office.

Finally, due to additional technical complications in processing the final paperwork with the MHFA on which we assisted, the project closed in January of 1987.

Mr. Chairman, as you are well aware, I have not served in the United States Senate in 10 years. I have divided my time among my private law practice, consulting and directorships of corporations. I have not sought public office and have only appeared before this committee once, in 1979, as an unpaid advocate and chairman for a nonprofit group, the National Low-Income Housing Coalition.

Most of my time has been devoted to my business affairs and my family.

Mr. Chairman, members of the committee, as I am sure you can appreciate, it is not pleasant to come before this committee to justify my fees to clients or to substantiate the work I have performed over the years.

It is indeed unfortunate to find myself in the news with vague innuendoes, negative implications and questions about my integrity.

But, let me assure you that I do welcome this opportunity to appear before you and to set the record straight.

Mr. Chairman and members of the committee, I applaud you for your commitment to developing a new national housing policy and, in all honesty, would be more comfortable testifying before you on the landmark housing legislation you are developing.

I look forward to continuing to work with you and members of this committee towards our common goals of providing decent housing for all Americans.

I see the yellow light is still going on, as usual. And I shall conclude my statement.

The CHAIRMAN. Thank you, Senator Brooke. We appreciate your testimony today. We asked you if you would appear and you agreed to do so without any hesitation. And I appreciate the statement that you have made.

You have been around this business long enough—I'm talking about politics and public service—and when there's a pattern that starts to develop that doesn't look right, you've got a very keen eye, as keen an eye as anybody I know.

You were present earlier when I read the list of people who made large fees off these programs. Now, you've got the individual facts that relate to your involvement and you've just laid those out. Putting those to the side for a minute, when you look at this whole pattern of activity and you see the size of the fees and you see them going to people with these connections, particularly to people who had worked just a short time before in the Department of

Housing and Urban Development, who go out into the private sector and make large fees, isn't that troubling to you in terms of that general pattern when you see that listing?

Mr. BROOKE. Well, Mr. Chairman, please don't ask me to sit in judgment on the work product or the fees that were charged by other persons for what they did. I don't think that's a fair assessment or call for me personally to make.

Mr. Chairman, I had hoped Senator Bryan, whom I don't know—would have been able to be present for my testimony. He and Senator Graham, who I am meeting for the first time, asked very important questions concerning the system of allocation of Mod Rehab units and the use of consultants.

Really, it seems to me, Mr. Chairman, we are raising a question about the appropriate interface between the public and private sectors. That is a perennial question in an economy where Government programs encourage the use of private sector market participants to participate to achieve public purposes.

When persons come out of public life, and I came out involuntarily, as you know, they have to make a living. I personally stayed in Washington because Washington was my original home. My family lives in Washington, DC I'm a lawyer by profession. And some of you some day—I hope not soon, until you do so voluntarily—will come out and you will have to make a living also.

If you're a lawyer, you may choose to practice law or become a consultant or whatever else you propose to do. It is commonplace in Washington for those who leave Government to interface with the Government in various capacities. Those who were on congressional committees like Foreign Relations sometimes end up representing foreign countries. Those who were on Commerce Committees sometimes end up representing clients before the FCC and the FTC. It goes on.

That is the Washington system. Frankly, HUD has not had these kinds of problems—to my knowledge, and as you know, I was on this committee for 12 years, and the Ranking Member and very much concerned with Housing legislation. As a matter of fact, I worked extensively on low-income housing legislation.

Therefore, Mr. Chairman, it hurt me when a national television news program spread across the screen a picture of James Watt and me and the narrator said:

> In a HUD housing scandal, former Secretary James Watt pocketed $300,000. Former Senator Edward Brooke received $183,000 for a project. A former Special Assistant to the HUD Secretary received more than a million dollars. He further went on to say that these people had opposed the HUD program when they were in office and were not profitting from it. Mr. Chairman, I can't recall the exact language, but that is the substance.

They painted with a broad brush. The fact is that I have been fighting for low-income housing legislation in not only the 12 years that I was here, but I've been fighting for that legislation the 10 years I haven't been here.

And, yet, so far as the public is concerned, from reading the report, they could well believe that I was one of those persons who profitted by legislation that I had fought against when I was a member of the United States Senate.

It is not a fact. It is false and it is damaging and it has hurt me—not only emotionally hurt me, but it has hurt me privately and in my practice.

The **Chairman**. That's one of the reasons you were invited here today, so you would have an opportunity to make the very comments that you just made.

Mr. **Brooke**. And I appreciate the opportunity.

The **Chairman**. I think it's worth noting in terms of differentiation, I make a distinction between the people who hold the job in the Department of Housing and Urban Development 1 day and literally a short period of time later go out into the private sector and cash in with what I think on their very face are excessive fees.

That doesn't happen to be the situation that attaches to you, as you made very clear in terms of the fact that you've not worked in that Department. You've been out of the Senate for 10 years and you've laid out the factual case as you see it with respect to the projects you were involved in.

Setting that to the side, I would be very surprised, however, if any thoughtful person was not troubled by the appearance of all of the insiders who cash in on this program.

I think it's offensive. I think it's offensive on its face. It may very well be illegal. We don't have a final determination on that. But as one who has fought over the years for these programs, I would think that you would be as offended as I and I think other members of this committee, by what, in effect, became almost a form of looting by people who had inside connections.

Mr. **Brooke**. Mr. Chairman, if that is a fact, I not only would be offended, I am offended. And as an old Attorney General, if it's in violation of the law, I would prosecute to the full extent of the law. And that is a fact.

The **Chairman**. Let me just ask a couple of things here. With respect to you mentioned Mr. Clayman. He said in his response to the IG, who was just here a moment ago, that he had never met you.

Mr. **Brooke**. That is not true. That statement is false, Mr. Chairman. I have given you a specific date that Mr. Clayman came to my office. And I remember it so clearly. My associate remembers that he brought her a box of truffles because she had been so kind to him on the phone.

Whether there's some mix-up in the interpretation between what he said to the IG when he came in, I have no knowledge. But Mr. Clayman is a very fine gentleman. I am sure there's some misunderstanding, that's all I can say.

But he did come to Washington. He met me in my office. As for the number of calls—he is reported to have said there were a few calls, and the papers made a lot of that. And that was fair for the papers to say because it was in the report.

But the facts are that there were not a few calls, there were dozens of calls over a period of 4 years.

The Chairman. Now, apparently, am I correct in noting that the amount that you received with respect to the work on the Cobbet School was a figure of $150,000?

Mr. **Brooke**. That's correct.

The CHAIRMAN. And that was paid by Mr. Clayman. Is that correct?

Mr. BROOKE. Yes, I sent him several invoices that he paid. My services were spelled out. Yes. I think he finally paid the bill in 1987 if I'm not mistaken.

The CHAIRMAN. It's my understanding that when he was asked by the Inspector General what had taken place for that amount of money, he claimed he didn't know.

Are you aware of that? Have you seen that in the report?

Mr. BROOKE. I am pleased that you have asked me the question because I've seen it in the papers and it is in the report, so the papers took it directly out of the report. Mr. Chairman who knows how the IG representative asked the question.

Was the question to Mr. Clayman:

"To whom did Senator Brooke talk? What did he do?"

Or, "How did he handle this matter?"

If so, Mr. Clayman probably said: "I don't know," and that is quite different from what has been reported.

But I think Mr. Clayman was a very satisfied client. I think Mr. Clayman was very satisfied that I did all the work I could for him. I think that I gave him the best advice and counsel that I could possibly give him.

And I think you'll just have to ask Mr. Clayman that.

The CHAIRMAN. To summarize, and then I want to yield to my colleagues, your testimony today is that you have in your work records sufficient detail that supports what you've said here today, that you feel that you've been able to reconstruct work that you did on this project that would constitute how many hours of activity?

Anyway to estimate here?

Mr. BROOKE. Over a period of 4 years, there were a lot of hours. But, you know, when I set a fee as a consultant, sometimes the same as a lawyer, I take several things into consideration: the complexity of the problem, time, as you pointed out, the energy, the amount of work I put into it. And yes on the valuation of my services to the client.

The CHAIRMAN. Let me ask you one other question. Have you acted as a consultant or as an interface with other clients in activities with the Department of Housing and Urban Development that involved grants or awards?

Mr. BROOKE. Yes, I said so in my statement. Yes, I have.

The CHAIRMAN. Dozens and dozens of clients would you say?

Mr. BROOKE. No, Mr. Chairman. I would say of my total work, about 80 percent is in the practice of law. And I would say less than 10 percent of my work has been with HUD matters. Less than 3 percent with this kind of HUD matter. I have worked on community development programs and other HUD programs as well. I don't want to rely too much on memory but, yes, I have worked with other programs.

The CHAIRMAN. Let me yield to Senator Shelby.

Senator SHELBY. I want to yield to Senator Graham now. And then I'll come back.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. I appreciate Senator Shelby's courtesy.

Mr. Chairman, I'll have to leave for about 10 minutes after I complete my questioning.

FUNDS ALLOCATED ON A DISCRETIONARY BASIS

Senator, thank you very much for your very concise and helpful statement. I was struck by the first paragraph of your statement in which you state that the funds began to be allocated in the section 8 mod rehab funds on a discretionary basis rather than on the basis of formula. This decision was made by the Congress because there were insufficient dollars to provide each community with its fair share of funds.

The impression that I got from the Inspector General was that the pre-1984 process had been a fair share allocation from a central office to the HUD regions.

Mr. **Brooke**. To the regions, correct.

Senator **Graham**. Then, at the regional level, a competitive process to determine applicants who actually received funds.

Mr. **Brooke**. I think the way it worked, Senator, if my recollection is correct, HUD would put out a NOFA, which is a notice of funds available, which would go out to the regions.

Then the regions would send this out to their nonprofit agencies. Then the nonprofit agencies would send in a list of proposals. And then the regions would send back the whole package to HUD. HUD would then make an allocation of the funds after reviewing them, looking at questions of need, low-income housing, lower-income family population, economically depressed areas, that sort of thing, and make a judgment call. Then make the awards and send it back to the region.

And that region would have to work with yet other proposals they had. That's the way they were awarded.

After 1984——

Senator **Graham**. I'm talking about after 1984. In that pre-1984 period, were there some known standards, some guidelines, criteria, maybe even a quantification of values process by which individual applicants were reviewed and awards made or withheld?

Mr. **Brooke**. I think that's what I was attempting to give you based upon the need—economically depressed areas, low income population, these particular sites had to be at that particular site. The amount of repairs that were necessary.

For example, you'd either repair or replace a whole system. It might be a heating system, it might be a roofing situation. All of those are factors which would be taken into consideration.

Senator **Graham**. The impression that I get from your statement is that after 1984, it went from somewhat of a merit-based objective standard allocation to a discretionary allocation.

Is that correct?

Mr. **Brooke**. Yes. I think what happened was, when Congress said you could waive the fair share, then that automatically meant that it would become a discretionary matter with HUD.

And it's my understanding that there was established a committee of three persons—the Assistant Secretary for Housing, a special assistant to the Secretary who would sit on the committee, and I think the Under-Secretary of Housing.

There was a committee of three that would review presumably the same criteria and awards and allocation would be made.

The CHAIRMAN. Would the Senator yield at that point?

I'm told by staff that there was a request from the administration for that change and that the Congress agreed in the appropriations process to accept that change on the basis of an administration request.

That's the history as we've been able to detail it.

Mr. BROOKE. The Chairman may be right. I don't know.

The CHAIRMAN. I wouldn't expect that you would. And I only make that point because I think——

Mr. BROOKE. That possibly may be true.

The CHAIRMAN. It's an important point. You've tracked that down and that's what we've been able to reconstruct.

Mr. BROOKE. But it did change in 1984, I'm sure of that.

Senator GRAHAM. Did you have any clients during the post-1984 period who were unsuccessful in getting section 8 mod rehab?

Mr. BROOKE. Oh, yes.

Senator GRAHAM. And those who were unsuccessful, was there any means——

Mr. BROOKE. Not only unsuccessful but a decrease in the number. I think even in the two projects I have discussed, there was a decrease in the number of units that were asked for or requested.

Senator GRAHAM. Was there any procedure within the Department by which the judgment made by this three-person group could be challenged based on some statistical or quantifiable standards?

Mr. BROOKE. Well, I never appealed the decisions, Senator Graham.

Senator GRAHAM. The question is was there a means?

Mr. BROOKE. I just don't know. I don't know whether an appeal would have been successful, as you said. But, in doing your work, you try to get as much information as you can possibly get U.S.S.R. in to support your proposed project.

You have to say:

Look, this is an area in need. We had to get as much support as we could possibly get, including local officials, in order to make a strong case that there was a real dire need.

Now, in disaster areas, for example, that would be one of the unusual circumstances which would require priority consideration.

Senator GRAHAM. I'm going to ask for the yellow light on. I'm going to ask a couple of indelicate questions.

Were the fees that you received for your work in these two projects consistent with the fees that you would receive from other non-HUD-related projects of similar complexity?

Mr. BROOKE. I think less, Senator Graham. I think they were less. One of these is $33,000, I think, over a period of several years—I think it came in in 1986. I'm talking now about the Crystal Park Project, and I'm relying on memory, Mr. Chairman, so bear with me.

I think, in 1986, the Crystal Park Project came in. There was at that time a proposed program for 155 units under MHFA, which is the Massachusetts Housing Finance Agency.

And the project had SHARP money, which is State Housing Assistance Rehabilitation Programs. We had to review all of that.

They came back to us then. It was on and off whether they could use section 8 mod rehab.

Then there was the availability question. I mean, yes, my $33,000 fee was low. I would get more money for that in private practice, for a matter of similar complexity.

Senator GRAHAM. The second indelicate question:

Were the fees that you or other people who dealt with this HUD program any different after 1984? That is, after it became discretionary, than prior to 1984, when there were presumably some objective standards?

Mr. BROOKE. I can't speak for others. For me, the answer would be no.

Senator GRAHAM. A last question, and I'm sorry, Mr. Chairman, to go over.

But, you indicated in your remarks that you had experience in a number of other HUD programs in addition to this one, that this was, in fact, only 3 percent of your time.

Are there any other HUD programs that the Inspector General ought to be looking at, based on your experience?

Mr. BROOKE. I was surprised when the Inspector General looked at these projects and when his representatives came to see me. When I read my interview statement, I was shocked. I didn't even recognize my statement. It was not the subject matter we discussed.

Most of the conversation was on the Fund For Africa, which I had never heard about. And I said, "Well, what's wrong with the Fund For Africa? It seems to me like a laudatory purpose."

Then it dawned on me, being an old prosecutor myself, I said, "Are you saying that the money that was collected for the Fund For Africa was used for some purpose other than that for which it was intended?"

And the young man said, "No, I'm not making that allegation, but did you make any contributions?"

I said, "I never made a contribution to the Fund For Africa. No one ever asked me for a contribution for the Fund For Africa."

And it was at that time, I think I was told that one of my clients had made a $500 contribution to the Fund For Africa. They said, "How well do you know Mr. Demery?" I said, "I think I met him on one occasion. I've talked to him on the phone maybe once or twice. But I think that's all."

And they went down the list of HUD officials. And, frankly, I was shocked by it. And I had no idea when they came to see me that they were looking any irregularity on these projects.

Senator GRAHAM. And you have no other recommendations of programs that would warrant Inspector General's audit?

Mr. BROOKE. I think, your Oversight Committee, and the Inspector General's office have a continuing oversight and close supervision of all of the HUD programs and how the Federal taxpayers' money is being spent.

Senator GRAHAM. Thank you.

The CHAIRMAN. Senator Shelby.

TIME SHEETS

Senator SHELBY. Thank you, Mr. Chairman.

Senator Brooke, as a lawyer, did you keep some time sheets on the amount of work you did on this? You said it went over a period of years.

Mr. BROOKE. No, I kept no time sheets on this.

Senator SHELBY. Did your paralegal or secretary keep sheets for you?

Mr. BROOKE. I think we have a record of calls and discussions. That kind of sheets, yes.

Senator SHELBY. When you had calls relating to this, do you have a central billing system in your office where you attribute these costs to what you're doing somehow?

Mr. BROOKE. I have such an arrangement at my law firm. Not as a consultant, no.

Senator SHELBY. Sure, as a lawyer.

Mr. BROOKE. As a lawyer, yes, we do billings.

Senator SHELBY. In this situation that we're talking about, were you acting as a lawyer or as a consultant?

Mr. BROOKE. As a consultant.

Senator SHELBY. And you distinguish between those two in your practice, do you not?

Mr. BROOKE. Yes, I do.

Senator SHELBY. In other words, this had nothing to do with law practice. This was based on your knowledge and so forth.

Mr. BROOKE. There was a law firm involved I think in both of these cases. The clients had law firms. I was their consultant.

Senator SHELBY. When we're talking about a discretionary fund or a discretionary situation at HUD, aren't we basically meaning that the discretionary equals political contacts? You're a former Senator. This is a Republican Administration.

If you look down the list of other people from James Watt to Richard Shelby—the other Richard Shelby—to Louie Nunn, Edward Brooke, Fred Bush—aren't all of you politically connected to the administration?

Mr. BROOKE. I would hope, Senator.

Senator SHELBY. Not what you hope. Isn't this true?

Mr. BROOKE. No, I don't think it's true. I think the hearings should focus on policy, not politics. You should go back and look at the record and I think you will find Democrats and Republicans—I don't think it matters which—appear before the various agencies of the Federal Government every day.

Senator SHELBY. Mr. Brooke, you at one time were a prosecutor. I believe you were the Attorney General of your State prior to being a U.S. Senator.

Mr. BROOKE. And Chairman of the Boston Finance Commission, which is the same kind of job.

Senator SHELBY. If you were in the Justice Department right now, would you be pursuing this—what you see and what you hear—for possible criminal violations? If you were in the Justice Department—this is a hypothetical. You mentioned you were a former prosecutor. Would you be doing that?

Mr. BROOKE. If I found sufficient facts in this report to merit it, I would.

Senator SHELBY. You would pursue a criminal investigation?

Mr. BROOKE. If I found sufficient facts. I was very careful when I was Attorney General and I'm very careful now.

Senator SHELBY. Right. Were you here earlier when the Inspector General testified?

Mr. BROOKE. Yes, I heard his whole testimony.

Senator SHELBY. Do you have any disagreement with his findings as he related to the Committee today?

Mr. BROOKE. I'm not privy to that information, Senator.

Senator SHELBY. But you heard some of his testimony?

Mr. BROOKE. I heard what he said. I'm certainly not going to support what he said.

Senator SHELBY. How do you differ?

Mr. BROOKE. I don't disagree, but I can't agree with it because I am not privy to his information.

Senator SHELBY. You don't have all the data.

Mr. BROOKE. I don't have any of the data to support that. I can only speak about what I was involved with.

Senator SHELBY. If you didn't keep any time sheets at all and I think you related that, if you didn't keep up with how many hours you put in or days you put in, how did you arrive at a fee of $150,000, I believe it was, on that one project?

Is this out of your head or is this based on a number of projects?

Mr. BROOKE. I think I have described already how I arrived at that.

Senator SHELBY. How is that?

Mr. BROOKE. The time, as I said.

Senator SHELBY. But how did you compute the time? That was the central question.

Mr. BROOKE. No. 1, it was 4 years. I wasn't working on this for 4 years, of course——

Senator SHELBY. I understand that, Senator, but you said you didn't keep up with it. You said you didn't keep time sheets.

Mr. BROOKE. I didn't keep time sheets, that's correct. That's what I said, but I didn't say I didn't keep up with it.

Senator SHELBY. Did you actually have a file?

Mr. BROOKE. Of course. I had the calls that were made back and forth from Mr. Clayman to me to the regional office, to the central office, and the research that we had to do. All of those things.

Senator SHELBY. Have you furnished that information to the Inspector General, or to the FBI or anyone?

Mr. BROOKE. No one ever asked me about these projects.

Senator SHELBY. If they asked you, would you share this with them?

Mr. BROOKE. Of course I would.

Senator SHELBY. But, again, you said you worked on it 4 years. But you didn't keep up with what you did. I asked you about time sheets.

Mr. BROOKE. Oh, yes, I know exactly what I did. I've said what I did; in this case, more than that I can supply.

Senator SHELBY. A $150,000 worth?

Mr. **Brooke**. Oh, yes. That's not a lot of money in the sense of a 4-year commitment, Senator. As I think you may find out.

Senator **Shelby**. I think that we would like to know exactly how you arrive at your fee just like we'd like to know how these other people that are not before us arrive at their fees. And I believe the taxpayer needs to know all this.

And you would agree with that?

Mr. **Brooke**. Of course.

Senator **Shelby**. Is this a situation, Senator Brooke, where a lot of insiders or well-connected people politically just cashed in on this program because it was set up politically with the discretionary funds to award not people on merit, but people that were politically-connected?

Mr. **Brooke**. Senator, don't ask me to make a judgment on others.

Senator **Shelby**. On yourself. What about yourself?

Mr. **Brooke**. Of course I'm prepared to make such a judgment. Senator, I had no influence in the administration. I disagreed with a lot of the programs. I fought the administration on the reduction of funds for the Mod Rehab Program. As I said, I had nobody inside. I had no pipeline. There was no contact, as was said earlier, that I had that I could rely upon.

I didn't know any of the persons at HUD before I began to work with them on these projects. Never. I never met them. I don't think there was one other than the Secretary, whom I'd met years ago but was not a close friend.

I worked with HUD personnel as competent professional people, and I consider myself a competent, professional lawyer and consultant.

Senator **Shelby**. My time is expired. Thank you, Mr. Chairman.

The **Chairman**. Senator Shelby, I think we have four other witnesses that we need to hear from today. They're all important witnesses. If you have anything else?

Senator **Shelby**. Mr. Chairman, I've got to go preside over the Senate. I hate to leave.

The **Chairman**. It's important that we try to have you come back if you can.

We'll see if we have to find somebody else.

Senator Brooke, I appreciate your testimony today.

Mr. **Brooke**. And let me say, Mr. Chairman, to Senator Shelby, we have never met before but I appreciate your penetrating questions because, as you know—I don't know whether you're a lawyer or not, but you don't get the facts——

Senator **Shelby**. I was at one time. Probably not much of one. [Laughter.]

Mr. **Brooke**. I'm always afraid of the fellow who says he's an old country lawyer.

But let me say this to you. You don't get the facts until you ask penetrating questions. And I appreciate your probing questions which have enabled me to give you the facts. Mr. Chairman, I thank you for asking the questions about the conflict between Mr. Clayman's statement and what I said in my statement.

But I think your enlightened staff will find out what the facts are. I stand on the facts as I have given them to you, Mr. Chairman.

The CHAIRMAN. Thank you. We appreciate your testimony today.

Let me now indicate what our approach will be for the rest of the time today. We'll have other members coming back, they've indicated to me. We're going to go next to the other Richard Shelby, then to a panel of two witnesses, Judith Siegel and Fred Bush, and then finally to Mr. Melvin Adams.

I envision that the testimony we're about to get is very important testimony for the committee, and I want to stress that fact. I think what has developed already this morning indicates that these are extremely important matters still under investigation—and under investigation by the IG, under investigation by the Justice Department, and certainly under investigation here by this committee.

We're talking about serious matters, and I want that understood all around so that no one is misled about that fact.

Let me now call Mr. Richard Shelby to the witness table. Mr. Shelby. Let me ask you to stand and raise your right hand.

Whereupon, Richard Shelby, was called as a witness and, having been duly sworn, was examined and testified as follows:

The CHAIRMAN. Mr. Shelby, do you have an initial statement that you want to make? If not, I'd like to get into questions.

Mr. SHELBY. Thank you, Senator.

TESTIMONY OF RICHARD SHELBY, FORMER CONSULTANT, WASHINGTON, DC

Mr. SHELBY. Let me begin by saying that it was only on Friday of last week that I learned of your interest in having me here to come and testify before your committee. Likewise, it was only yesterday that I was able to obtain portions of the Inspector General's report relating directly to me.

Therefore, I really haven't had an opportunity to review it carefully. As a consequence, I really do not have a formal statement in this sense to make at this time. I would like to say that I feel that the interview that I had with the representative from the Inspector General's Office was very thorough and very complete and raised all the relevant facts that relate to my involvement in the issue at hand.

Beyond that, I simply say that I want to be cooperative with you and other members of the committee. My intent here today is to try to answer your questions as forthrightly as I possibly can.

The CHAIRMAN. I appreciate that. And I appreciate the points you raised about preparing yourself adequately for this hearing. As the Chairman of the committee, I'll be understanding of that fact. Let me ask you now:

EMPLOYMENT WITH THE FEDERAL GOVERNMENT

What was the nature and term of your employment with the Federal Government?

Mr. SHELBY. My employment with the Federal Government ran roughly from January of 1981 to June of 1981.

The CHAIRMAN. What assignment? What was your role?

Mr. SHELBY. Yes, sir. My official title was Deputy Director of White House Personnel.

The CHAIRMAN. During the period that you were involved in personnel appointments in the administration, were you involved in having a role in any of the people who were recommended or appointed in the Department of Housing and Urban Development? And very particularly that ended up in this Mod Rehab Program?

Mr. SHELBY. No, sir, I was not.

The CHAIRMAN. None at all?

Mr. SHELBY. None of the people that were involved in the Mod Rehab Program, no, sir.

The CHAIRMAN. What about Debra Dean?

Mr. SHELBY. No, sir, absolutely not.

The CHAIRMAN. In the sense that you did not have any involvement in examining her interest in the Government, in bringing her into the Government, in bringing her into the Department of Housing and Urban Development?

Mr. SHELBY. None whatsoever, sir. In fact, I did not meet Ms. Dean until 1985.

The CHAIRMAN. So, then, your answer to that is categorical. You had no part in dealing with any of these folks on the front end as they were coming into Government service?

Mr. SHELBY. Yes, sir, to the best of my recollection, that's correct.

The CHAIRMAN. Yes, go ahead.

Mr. SHELBY. I was just going to add the point that really my role in my position was not so much to be involved in the day to day operation of the internal workings of the office, but rather I was more oriented toward external affairs dealing with those individuals that were involved in the campaign—state party chairmen, national committee men and committee women, people at that level.

I'm not suggesting that I was totally disengaged, but that wasn't my principal focus.

The CHAIRMAN. But I assume it related to the possibility of jobs in the administration. Wouldn't the Personnel Office——

Mr. SHELBY. Yes, sir. For example, I would receive the names of Reagan/Bush State Chairmen—I should say received names from State Party Chairmen, of people who worked in the campaign. And based upon their education and experience would be able to provide a contribution to the new administration in some capacity.

The CHAIRMAN. You mentioned that you met Debra Dean in 1985, to the best you recall?

Mr. SHELBY. Yes, sir.

The CHAIRMAN. Can you just give us the circumstances of the acquaintanceship that developed and what followed thereafter?

Mr. SHELBY. Yes, sir, I'll be happy to.

Following, or I should say beginning in late 1984, I decided to become less a political activist, I suppose you'd say, and more of a business man. And so began a small consulting business.

The CHAIRMAN. When did that occur?

Mr. SHELBY. This would have been in December of 1984. It was in that capacity that I subsequently met her.

The CHAIRMAN. You were out of the Government at that time?

Mr. **Shelby**. Yes, sir, I was. I had been out of the Government since June of that year.

The **Chairman**. So you started this small consulting firm.

Mr. **Shelby**. I'm sorry, Senator. I had been out of the Government since June of 1981.

The **Chairman**. Very good. So in 1984 though you started this small consulting business. Is that correct?

Mr. **Shelby**. Yes, sir, that's correct.

The **Chairman**. In conjunction with that, you say—was it in conjunction with that that you met Ms. Dean?

Mr. **Shelby**. Not at that point in time. As I say, that was sometime later, the next year. I honestly can't remember at what point in 1985 that was. My recollection would be that it was probably in April or May of that year.

The **Chairman**. Now, take this from the beginning of your business to your decision to get involved in HUD type activity. Do you have background in that area?

Mr. **Shelby**. No, sir, not as such.

The **Chairman**. How did you happen to decide to get involved in that area?

Mr. **Shelby**. Again, I'm not absolutely certain of the date, but in roughly April or May of that year, I was approached by a friend who had been contacted by a developer who had an interest in applying for funding under the Mod Rehab Program.

And his question was:

Would I be interested in working with him in trying to win something for the project of the developer who had contacted him.

The **Chairman**. Can you tell us who that friend was who contacted you?

Mr. **Shelby**. Yes, sir, it was Mr. Eli Feinberg.

The **Chairman**. So what followed from there?

Mr. **Shelby**. From there, well, actually, I should back up and preface what I'm going to say by saying:

After having had my own business for several months, I determined that it was going to be necessary for me to either expand my business or else to align myself with a larger firm. Due to the fact that I had been successful, I had a number of clients.

I, quite frankly, was a bit over-extended. Therefore, I was either going to have to make a capital contribution to expand the scope of my own personal operation or, as I mentioned, join a larger firm that could provide me the necessary support.

The **Chairman**. How big was your firm at that time?

Mr. **Shelby**. At that time, it was only myself and I shared a secretary.

The **Chairman**. So you had a part-time secretary and yourself and that was the nature of the business that you had started when you were approached by Mr. Feinberg.

Is that right?

Mr. **Shelby**. Yes, sir, that's correct.

The **Chairman**. What followed from that?

Mr. **Shelby**. As I said, as a result of going through this thought process, I joined a Washington-based firm, it was in my work with that firm that the agreement was reached by Mr. Feinberg and his client.

The CHAIRMAN. What was the name of the Washington firm?

Mr. SHELBY. The Keefe Company.

The CHAIRMAN. The Keefe Company?

Mr. SHELBY. Yes, sir.

The CHAIRMAN. So you joined the Keefe Company, then you pursued establishing this relationship as part of the Keefe Company with Mr. Feinberg.

Is that correct?

Mr. SHELBY. Yes, sir, that's correct.

APPROACHES MADE TO HUD

The CHAIRMAN. To take us up to the time of how the approaches were made to the Department of Housing and Urban Development, what was done?

Mr. SHELBY. Yes, sir. So far as that particular project was concerned, probably 98 percent of all my conversations, contacts, et cetera, were with Mr. De Bartolomeis.

The CHAIRMAN. We may get you to spell that name later for the stenographer. [Laughter.]

I want you to take a minute and describe for us. You've gone out in the business on your own. You're trying to start a business. You have no particular background in housing or urban development kind of activity. You go into the Keefe firm.

Mr. SHELBY. And that's one thing that was in the Inspector General's report that I would like to just touch on, if I could beg your indulgence.

The CHAIRMAN. Please do.

Mr. SHELBY. I feel that as my comments were paraphrased in the report, although they touched upon the flavor of what I said, I don't believe that they touched upon the substance. The observation that I made to Mr. Kane at the time was that I wouldn't hold myself out as an expert on this particular program.

In other words, there were certain technicalities of the law that I wouldn't presume to suggest that I do understand. But, from a macro standpoint, from a conceptual standpoint, I do feel that I had some knowledge of the program, in part attributable to work that I had done years ago as a member of the Senate staff.

The CHAIRMAN. Tell us about that.

Mr. SHELBY. I served on Senator Bartlett's staff from Oklahoma for a period of time, although I wasn't a legislative director focusing on housing. I coordinated the field office operations and was approached by different business people relative to housing and urban development problems that they were attempting to deal with in their respective communities in their respective businesses.

So, again, I don't want to make it appear as if I consider myself to be an expert but, conversely, I don't want the record to make it appear as if——

The CHAIRMAN. That you were a rank novice.

Mr. SHELBY. An ignoramous with absolutely no knowledge whatsoever, no, sir.

The CHAIRMAN. How much money did you receive in fees connected to these mod rehab contracts?

Mr. SHELBY. Are you talking about collectively?

The CHAIRMAN. Yes. How much money did you personally receive, or did your firm receive for the work you did on these contracts? All the contracts.

Mr. SHELBY. Yes, sir. As Senator Brooke said, thank you for asking the question because it affords me again to correct the record, which I believe is not only inaccurate but misleading.

The figure, as you know from noting the report on the chart that appears in the report, is $442,000. Now that in my opinion, as I indicated, is not correct.

In the written explanation, it basically clarifies the point that it is, at least in my opinion, inconsistent with the charter. And by that, I mean, if you look at the chart, and I would add that it was I believe on the basis of that chart, that the news article that made reference to me some time ago was based—and I have the same concerns as Senator Brooke expressed in that regard—obviously, it was focused on the chart.

PROJECT FEES

In fact, as I indicated a moment ago, so far as the project was concerned, I was working on that project as a part of the Keefe Company team. And the fee that was received for doing the work on that project was $225,000.

The CHAIRMAN. Which project was that?

Mr. SHELBY. That was the Florida project.

The CHAIRMAN. So that one was $225,000.

Mr. SHELBY. Yes, sir.

The CHAIRMAN. Are you going to give me the rest then to get to the total here?

Mr. SHELBY. Yes, sir.

The CHAIRMAN. That's the Florida one.

Mr. SHELBY. Yes, sir. And the second project in question, the Maryland project, was—or the fee was, I should say, $220,000.

So that would bring you to a total of $445,000 after you read the 442.

The CHAIRMAN. Right.

Mr. SHELBY. That second fee, Senator, was split between myself and another consultant, who was actually the consultant of record. Again, who asked me to assist him with his work.

The CHAIRMAN. Who was that person?

Mr. SHELBY. His name was Andrew Sankin S-a-n-k-i-n.

The CHAIRMAN. So you split that fee 50/50?

Mr. SHELBY. Yes, sir, that's correct.

The CHAIRMAN. So that fee, you got half of it and somebody else got half of it?

Mr. SHELBY. Yes, sir, that's absolutely correct. In that instance, again, I would emphasize that I wasn't even the consultant of record. I came in post hoc facto, so to speak.

Senator, I'm not trying to filibuster here.

The CHAIRMAN. I know you're not.

Mr. SHELBY. But this is important to me.

The CHAIRMAN. I want you to have the time to say precisely what you want to say.

Mr. SHELBY. Yes, sir. If you look at that in the very best light, there's a $110,000 differential. Also, again, the initial fee went to the company rather than to me.

Now, I understand that that fee obviously inures to my benefit because I was receiving a salary from my firm. But to read the article that appeared in the Post and to just look at the chart in the document, it makes it appear as if I walked away with $442,000 in my back pocket. And that I think, clearly, Senator, was just not the case.

The CHAIRMAN. Can you tell us how much you were paid by the Keefe Company during this time period that covers these two contracts?

Mr. SHELBY. Yes, sir, $108,000.

The CHAIRMAN. $108,000 a year stretching over how many years?

Mr. SHELBY. About 3½ years, sir.

The CHAIRMAN. So your salary from the Keefe Company was $108,000 a year. Were there add-ons to that? Other benefits in that package?

Mr. SHELBY. No, sir, there were not.

The CHAIRMAN. $108,000. So when they received these fees, the entire $225,000 from Florida and half of the fee from Maryland, that went into the accounts of the company and from that you were then paid $108,000 a year.

Is that right?

Mr. SHELBY. No, sir, not quite. So far as the Florida project is concerned, that's correct.

On the second project, the Maryland project that I was involved with with Mr. Sankin, that, as I said a moment ago, and I apologize if I didn't make that clear, I did personally, myself, earn that $110,000 fee.

The CHAIRMAN. I think the question that's on the minds of many and on my mind:

What did you do to earn the $110,000?

Mr. SHELBY. Yes, sir. Senator Brooke made I think a very excellent point and that was the point that he made relative to the length of time that's involved in bringing one of these projects to a successful conclusion. And over a period of in one instance—and, again, I haven't had a chance to review the record that closely, for the reasons that I initially stated. But, to the best of my recollection, a period of a year or perhaps more.

MEETINGS AT HUD

During that period of time, there must have been at least three, possibly four meetings. There were many telephone calls.

The CHAIRMAN. Let me stop you right there. We're just talking about the Maryland project now?

Mr. SHELBY. Well, I really felt, Senator, that you were asking a more generic question about the process.

The CHAIRMAN. I'll take it either way. I just want to make sure we're talking about the same thing.

Mr. SHELBY. But, yes, that would be even more true in the Maryland project.

The **Chairman**. Were you thinking of Florida or the two combined?

Mr. **Shelby**. As I said, I thought you were asking a more generic question. So, therefore, I was trying to answer you from that viewpoint.

The **Chairman**. Let me be very clear on what I'm trying to get at. I don't want to be confusing at all during the questioning. I'd like to take either one.

Let's take either Florida or Maryland and I would like you to explain what went on, what you did, who you did it with and what constitutes the work that went on that earned this fee.

Mr. **Shelby**. Yes, sir. Again, a very protracted——

The **Chairman**. Which one are we starting with, Florida or Maryland?

Mr. **Shelby**. I'll start with Florida.

Again, a period, I believe, of at least a year, perhaps longer. During that period of time, a number of meetings at HUD.

The **Chairman**. What would be your estimate of the number of meetings?

Mr. **Shelby**. Senator, my recollection is three or four. It may have been one more.

The **Chairman**. Would you have records on that or not?

Mr. **Shelby**. Senator, not on 1985, no, sir.

The **Chairman**. At any rate, your recollection is three or four meetings at HUD over roughly that year's period of time.

Who took part in those meetings?

Mr. **Shelby**. Most of those meetings again were with Mr. De Bartolomeis.

The **Chairman**. You initiated the meetings? You called and asked for an appointment?

Mr. **Shelby**. Yes, sir.

The **Chairman**. And he saw you if you went in and you talked with him solely about the Florida project. Is that right?

Mr. **Shelby**. Yes, sir, that's correct.

The **Chairman**. So you had three or four meetings over that period of time. What else would have happened in addition to those meetings?

Mr. **Shelby**. There would be many telephone calls.

The **Chairman**. How many? Dozens?

Mr. **Shelby**. Yes, sir.

The **Chairman**. Who would those have been made to?

Mr. **Shelby**. In regard to the Florida project in most instances, Mr. De Bartolomeis.

The **Chairman**. The same individual?

Mr. **Shelby**. Yes, sir.

The **Chairman**. Other people in HUD? Did you have other contact points in HUD?

Mr. **Shelby**. Yes, sir, there were a few calls in conjunction with that project to Mr. Cushing. Again, my principal interface, I suppose you'd say, would be with Mr. De Bartolomeis.

The **Chairman**. Did you know him before the first meeting? Had you had prior contact with him?

Mr. **Shelby**. Senator, to the best of my knowledge, we had never met before.

The **Chairman**. Why did he give you the time of day when you called and said you wanted an appointment? What would prompt him to say, "Put Mr. Shelby down for 3 o'clock on Tuesday"?

Mr. **Shelby**. I can only speculate, of course. But my guess would be as I indicated earlier, I'd been very active on behalf of President Reagan in both of his campaigns at that point in time, and my expectation was that he was probably familiar with me as a result of those efforts.

The **Chairman**. Do you know is he a political appointee?

Mr. **Shelby**. Yes, sir, I believe he would be. I don't know if he was initially but certainly he was.

The **Chairman**. At the time you dealt with him?

Mr. **Shelby**. Yes, sir.

The **Chairman**. Did you have any part in his having been selected?

Mr. **Shelby**. No, sir, I did not.

The **Chairman**. Where is he now?

Mr. **Shelby**. To the best of my knowledge, he is in business in Colorado.

The **Chairman**. Do you know with whom he's in business?

Mr. **Shelby**. I do not know for certain. I think I know, but I don't know for certain so I would hate to, if I'm wrong——

The **Chairman**. No, let me tell you what our information is so you're not required to get out on that limb. Apparently he's in business with Mr. Winn and Mr. Abrams, who were referred to earlier, who obviously have been involved and done very well with this program, and who are former HUD people themselves.

Apparently, that's where he's now working.

So your calls went to him. Did you ever speak to Debbie Dean?

Mr. **Shelby**. On this project, and again I want to emphasize on this one, I'm not certain. I may have spoken to her on one or two occasions but I truly am not even certain that I did visit with her at this point in time.

The **Chairman**. Would you have talked to her on other projects at other times?

Mr. **Shelby**. Yes, sir, I did visit with her in regard to the Maryland project that you touched upon.

The **Chairman**. How did you establish the contact with her?

Mr. **Shelby**. Essentially, just as was true in the first case. I just called and asked for an appointment.

The **Chairman**. So you called, identified yourself and asked for an appointment. And then you were given an appointment and you walked in, introduced yourself. And that was the beginning of the relationship with Debbie Dean.

Would that be right?

Mr. **Shelby**. Yes, sir, that's correct.

The **Chairman**. When would that have probably happened? What year?

Mr. **Shelby**. This was the spring of 1985.

The **Chairman**. And after then, you met her and you had occasions with respect to other projects from time to time; to take just one, in the case of Maryland, that you cite, but to be in touch with her on those projects.

Mr. **Shelby**. On that one, yes, sir.

The **Chairman**. Would that be by phone or personal meeting?

Mr. **Shelby**. Both.

The **Chairman**. How many times would you say you met with her?

Mr. **Shelby**. To discuss that project, Senator, probably three or four times.

The **Chairman**. Coming back for a minute on the Florida project, you've identified three or four meetings as best you can remember, dozens of phone calls in almost every case to the gentleman, Mr. De Bartolomeis.

Were there other things that happened? Were there exchanges of correspondence? What else took place?

Mr. **Shelby**. Yes, sir. I of course also talked to the developer on numerous occasions, providing him with status reports, et cetera.

The **Chairman**. I'm more interested in your work with the Department of Housing and Urban Development. Anything there? Any exchanges of letters?

Mr. **Shelby**. Senator, it seems as if on one occasion I wrote to Mr. De Bartolomeis. Again, I'm not trying to hide behind the fact that I haven't had a chance to review the materials. I honestly can't be certain.

The **Chairman**. Would you check your files and see if perhaps that recollection is right. If there was a letter or an exchange of letters dealing with either of these projects; if you can find them in your files, I'd appreciate seeing them.

Did you maintain in your relationship with the Keefe Company at that time, did you maintain phone records or appointment records as to when you would be in touch? Did you do it either for billing purposes or just as a matter of the order of the way the office worked?

Mr. **Shelby**. Senator, not for billing purposes, per se. So far as the calendar is concerned, yes, I had an appointment book. It's long since been discarded at this point in time. So far as a telephone log—not a telephone log in the sense of one that I'm certain that you would maintain in your office, but on a legal pad on a daily basis keep track of calls.

And again, obviously, I haven't kept legal pads with cancelled telephone calls that I made back in that period of time.

The **Chairman**. Let me ask you this. As I understand it, were you the only person for the company that was doing the consulting work on the Florida project with HUD?

Mr. **Shelby**. No, sir.

The **Chairman**. Who else was involved?

Mr. **Shelby**. In addition to myself, the president of the company was involved.

The **Chairman**. Who is that?

Mr. **Shelby**. Mr. Clarence James. Also, I think—well, I'm certain that he was. I think there may have been another.

The **Chairman**. Did you do most of the work?

Mr. **Shelby**. I did most of the work, yes.

The **Chairman**. Most of the work would constitute these three or four meetings and the phone calls and perhaps one piece of correspondence? We're not sure about that. You're going to take a look and see that that might exist.

Is that the extent of it? Was there more involved than that with respect to the interfacing with HUD?

Mr. **Shelby**. Well, as I mentioned, numerous calls and also important to note, as I believe I did a moment ago, obviously, considerable contacts, conversations with the client. And then also of course there was work with the local housing authority by Mr. Feinberg, who was involved in the project as well.

MONEY OUT OF PROPORTION FOR AMOUNT OF WORK DONE

The **Chairman**. You've been around this town for a long period of time. You've served on the Senate staff at one time for a distinguished Senator with whom I've also had the chance to serve. You've just described activity. When I add it up in my mind and I say is this $225,000 much of work? It sounds to me like it's a small amount of work, and a large amount of money.

The money is way out of proportion to the amount of work that was done.

Doesn't that strike you that way?

Mr. **Shelby**. Senator, I certainly wouldn't deny that that's a substantial fee. Again——

The **Chairman**. It's more than the President of the United States makes in a year. That's just one measure of looking at it. But, to me, it looks to me like a lot of money. And that's a big fee.

Mr. **Shelby**. It certainly does to me also. But, again, I'm not trying to plagerize from Senator Brooke's script. But, again, the time element I think is an important consideration because although perhaps you're not working on the project day in and day out, it's always on your mind, so to speak, because of its importance.

In addition to that—I'm sorry. I've lost my train of thought.

The **Chairman**. In any event, I have to tell you there was no disrespect to you or the work you did. A fee of $225,000 sounds very excessive to me, even if it did stretch over a period of time, because I assume you were working on other activities as well. This wasn't the only thing you were doing.

Mr. **Shelby**. Yes, sir, that's correct.

The **Chairman**. You had a host of other activities. Did you have others with the Department of Housing and Urban Development?

Mr. **Shelby**. Yes, sir. In fact, I would like to spend some time talking about the Maryland project, the Fox Glen project.

The **Chairman**. We'll get to that. Let me ask you this. I just want to try to do it in some kind of an order.

Mr. **Shelby**. I'm sorry. I didn't mean to interrupt your train of thought.

The **Chairman**. I want you to be able to say for the record whatever we need to hear on that, or whatever you feel is important to say. But, for the moment, were there other HUD activities during the time that you were with the Keefe Company for which consulting fees accrued to the company that you were involved in, in other areas of HUD work?

Mr. **Shelby**. During the entire period of time——

The CHAIRMAN. Or at any time. I want to know how much more business you were able to do with HUD in other categories, whether or not it was when you were a part of that Keefe Company.

Mr. SHELBY. Yes, sir. I had any number of other projects that I was involved with during that period of time.

The CHAIRMAN. Did they culminate successfully, do you know?

Mr. SHELBY. Some of them did, yes, sir.

The CHAIRMAN. Would they have earned fees in this range?

Mr. SHELBY. Well, the largest fee other than the one that you're talking about in the mod rehab project would be the Fox Glen project in Maryland.

As I mentioned, in that case, the fee was $220,000.

The CHAIRMAN. Split 50/50. But now what about other projects? Can you recall from memory some of the other activities you've been involved in successfully that would have brought in fees off HUD contracts, HUD awards, HUD activities?

Mr. SHELBY. Yes, sir. I was involved in a UDAG project in Cleveland, Ohio, which came to fruition in I guess it was 1988 or 1987.

The CHAIRMAN. Do you recall what the fee was associated with that?

Mr. SHELBY. Senator, not specifically. Again, that wasn't even within the purview of what I thought we were going to be discussing. I guess we can look at it. But it was in that range. Actually, I think it was somewhat higher.

The CHAIRMAN. You mean in the range of several hundred thousand dollars?

Mr. SHELBY. Yes, sir, that's correct.

The CHAIRMAN. Can you establish that for us? It was probably several hundred thousand dollars. You just don't know the figure, but you'll get that figure for us.

Were there other projects like that, that you had a roll in, where HUD activity took place, when you were able to earn substantial fees?

Mr. SHELBY. The only other fee in that category would be, again, the fee earned in conjunction with the Maryland project.

UDAG FEE FROM CLEVELAND

The CHAIRMAN. Now, in the UDAG fee from Cleveland, would that have gone to the Keefe Company again and then you got your normal salary?

Mr. SHELBY. Yes, sir, that's correct.

The CHAIRMAN. So that was not direct like the Maryland project?

Mr. SHELBY. Yes, sir, that's correct.

The CHAIRMAN. Are there any other HUD activities that you can think of that took place where you were involved and that came to a successful conclusion beyond these two and the Cleveland UDAG?

Mr. SHELBY. There was a third mod rehab project, a very small project in Pennsylvania. The total fee of which was I believe either $15,000 or $17,000.

The CHAIRMAN. And that went to the Keefe Company?

Mr. SHELBY. No, sir, that came to me.

The CHAIRMAN. Were there any other HUD fees you can recall?

Mr. SHELBY. No, sir.

The CHAIRMAN. Do you think there may be ones that you just wouldn't remember without a thorough examination? Or do you have a clear enough recollection of your activities with HUD that this is really a complete list?

Mr. SHELBY. Senator, I believe, no. Thank you for prompting me because I was about to overlook one thing. There was another mod rehab project that I was involved in that did not come to fruition but for which I did receive a partial fee. Again, it was minimal. My recollection was it was $20,000.

The CHAIRMAN. Who paid the fee? Do you recall who the developer was in that case?

Mr. SHELBY. Yes, sir, it was Olney Properties.

The CHAIRMAN. Were you involved in other contracting kinds of situations with other agencies of Government beyond the Housing and Urban Development?

Mr. SHELBY. Yes, sir.

The CHAIRMAN. What other departments did you work with?

Mr. SHELBY. Over this period of time, I've done work of one kind or another at Commerce, Agriculture, and Transportation.

The CHAIRMAN. If I may ask, in those other areas, have they been in areas that have led to either contracts or awards for outside entities that you have helped represent?

Mr. SHELBY. No, sir. That as a general rule was far more issue-oriented.

The CHAIRMAN. Were you a consultant for those agencies or what?

Mr. SHELBY. Yes, sir.

The CHAIRMAN. What time periods would those cover?

Mr. SHELBY. This would have covered 1985 through 1988.

The CHAIRMAN. Give me a couple of illustrations. You said the Commerce Department. What did you do with the Commerce Department?

Mr. SHELBY. Made an inquiry there on behalf of a client who had an interest in receiving funds to subsidize the cost of a feasibility study relative to a business enterprise that he was interested in establishing in the Caribbean.

The CHAIRMAN. Was that successful?

Mr. SHELBY. No, sir, it was not.

The CHAIRMAN. Were you paid a fee by the individual who you worked for?

Mr. SHELBY. Yes, sir. It was more like what I suppose you would characterize as a more traditional type.

The CHAIRMAN. Can you tell us were there any areas in other departments where you went after a contract or you tried to represent a client where it was a successful effort and the contract was awarded, or monies made their way through to that client?

Mr. SHELBY. Senator, there were, but, again, I'm not trying to be evasive, but they were relatively far afield from what I thought we were going to be discussing.

I tried last night to read through the materials in the report that applied.

The CHAIRMAN. I understand. Let me tell you the reason I'm asking. I'm not trying to mouse-trap you into giving information that you haven't had a chance to prepare and think about, but obviously the Committee is concerned about the pattern of activity in the Department of Housing and Urban Development.

I think there's a pattern there that really is not as it should be. In the course of our discussion, in thinking about it, I'm wondering if there may be activity that's gone on in other departments of Government separate from HUD that may in effect show us the same kind of pattern. I hadn't thought about that either.

But, as you've just indicated, in your business activity, you were apparently involved with other Cabinet Departments going after contracts of one kind or another, some unsuccessfully, some apparently successfully.

You don't have them in front of you.

Mr. SHELBY. Yes, sir. I'm sorry. I didn't mean to interrupt.

The CHAIRMAN. Go ahead.

Mr. SHELBY. I perhaps misunderstood, but I thought the question that was asked was did I have any similar type things with or at, I should say, other departments and agencies. And my answer was yes.

But I wouldn't want you to draw the conclusion that that was the norm or that was typical. Much more of what was done was more typical of a standard situation in which work on behalf of a client relative to legislative initiatives issues, to use the generic term, lobbying type activities.

The CHAIRMAN. I would appreciate it just so that we can satisfy ourselves as to the whole pattern. I'd like a listing of your other activities with other departments that would have led to you either receiving fees directly or indirectly from the Government, whether it's in the Commerce Department, the Agriculture Department or any other department.

I'd like to see if there's a pattern of activity here that would raise questions. I don't presume that there is or isn't, but I'd like to see the facts so I'm in a position to judge. We've got the facts so far in the HUD situation and they're very troubling.

I'm about to yield to my colleagues here because we've got other witnesses to get to today. But it sounds to me as if the size of the fee that was generated with respect to the Florida project, $250,000 is an awful lot of money for what was done.

Obviously, if somebody can deliver the contract and there's enough money in the contract that you can slice off that much money and give it to somebody and it facilitates getting the contract, then, that's where the money comes from.

But that again raises the question:

Who gets the contract and who doesn't? Is there a pattern of favoritism? Is there a certain inside play going on so somebody gets that and somebody's going to get a chance to make a lot of money.

To me, those are very large fees for the amount of work that was done. This gets into the whole question of the competitive process and so forth.

I want to just ask two other things, then I'm going to yield to my colleagues here.

You still have your business?

Mr. SHELBY. No, sir.

The CHAIRMAN. What are you doing presently?

Mr. **Shelby**. I serve as the political director of the Republican Senatorial Committee.

The **Chairman**. You asked to put some facts on the record with respect to the Maryland case, and I said that I would give you the chance to do that right now. And then we'll yield to my colleagues.

HUD CONTACTED DEVELOPER IN ACQUIRING A PROJECT

Mr. **Shelby**. Yes, sir. One I think pertinent fact wasn't included in the Inspector General's report so far as that project was concerned. It was the fact that in that particular instance, the Department of Housing and Urban Development actually contacted the developer in question to determine if he might have an interest in acquiring this project. And their rationale for doing so was I think well-founded in that at that point in time they were involved in a lawsuit and were concerned about whether or not they could prevail in litigation.

If they didn't, they stood to lose a substantial amount of money. And, therefore, their motivation in approaching the developer.

So, in this particular instance, the developers' willingness to pursue the development of that project allowed the Government to recoup everything that was previously at risk, which included an outstanding mortgage of $3.4 million as well as approximately $900,000 in outstanding penalties and delinquent taxes.

In addition to that, the Department was also able to recapture I believe—and I can't be certain about this, but my recollection is 20 years of a 20 percent subsidy.

So I think that from the standpoint of the Government, not to mention the residents of the community where there was a clear need for low-income housing, were well-served.

The **Chairman**. At this point, let me introduce Senator Richard Shelby to Mr. Richard Shelby.

Senator **Shelby**. We've met.

Thank you, Mr. Chairman.

Mr. Shelby, are you connected with the Oklahoma Republican Party?

Mr. **Shelby**. Yes, sir.

Senator **Shelby**. And you still are, I suppose.

Were you at one time in the Reagan White House?

Mr. **Shelby**. Yes, sir, as I previously mentioned, I was.

Senator **Shelby**. I was not here earlier so I know what you're doing now. You're working with Senator Nickles over in the Republican Senatorial Committee.

Mr. **Shelby**. Yes, sir.

Senator **Shelby**. When did you leave the White House? I know you came from Oklahoma to Washington after President Reagan was first elected President.

Mr. **Shelby**. Yes, sir. I think you got a lot of my telephone calls.

Senator **Shelby**. We used to refer them to you.

Mr. **Shelby**. June 1981.

Senator **Shelby**. Was when you came?

Mr. **Shelby**. No, sir, was when I left.

Senator **Shelby**. What did you do when you left?

Mr. SHELBY. When I left the White House in June, I returned to Oklahoma to enter private business.

Senator SHELBY. What kind of business were you in? Consulting?

Mr. SHELBY. No, sir, it was in oil well servicing.

Senator SHELBY. Oil and gas?

Mr. SHELBY. Yes, sir.

Senator SHELBY. How long did you stay in that business?

Mr. SHELBY. I was there for about 7 months, through the remainder of 1981.

Senator SHELBY. Then what did you do in 1982?

RETURN TO WASHINGTON

Mr. SHELBY. At that point, I determined that I missed politics and Washington more than I ever dreamed I possibly would when I decided to leave. So I returned to Washington.

Senator SHELBY. In what capacity? A private capacity?

Mr. SHELBY. No, sir, I came back and was at the Republican National Committee's Campaign Directorate.

Senator SHELBY. How long did you have that job?

Mr. SHELBY. Throughout the 1982 election cycle.

Senator SHELBY. What did you do after that?

Mr. SHELBY. Following the 1982 election cycle, I worked for the next 10½ months as the manager of the Republican National Convention.

Senator SHELBY. For the 1984 Convention?

Mr. SHELBY. Yes, sir, that's correct.

Senator SHELBY. To move things along, when did you become a private consultant?

Mr. SHELBY. Following the 1984 election cycle.

Senator SHELBY. In 1985?

Mr. SHELBY. Yes, sir.

Senator SHELBY. And you've been headquartered here in Oklahoma or mainly here?

Mr. SHELBY. Mainly here, sir.

Senator SHELBY. During that time, starting in 1985, after the second Reagan Presidential win, did you start doing consulting then with HUD projects?

Mr. SHELBY. Beginning in 1985, yes, sir.

Senator SHELBY. How many projects have you been associated with just off the top of your head?

Mr. SHELBY. That have come to successful conclusions?

Senator SHELBY. Some of them hadn't, I know.

Mr. SHELBY. No, unfortunately, far more haven't than have.

Senator, I would guess probably seven or eight.

Senator SHELBY. Who first hired you to do some consulting to help them with the HUD projects?

Mr. SHELBY. Mr. Martin Fine.

Senator SHELBY. Who is that?

Mr. SHELBY. Mr. Fine is an attorney in Miami, Florida.

Senator SHELBY. Had you known him prior to this?

Mr. SHELBY. No, sir.

Senator SHELBY. Had you ever worked at HUD?

Mr. SHELBY. No, sir.

Senator **Shelby**. Had you ever been involved in housing before on a large scale?

Mr. **Shelby**. Yes, sir. Very briefly.

Senator **Shelby**. Was that Oklahoma?

Mr. **Shelby**. Yes, sir, when I was on Senator Bartlett's staff, I devoted some time to these types of related issues. Again, as I mentioned to Senator Riegle earlier, we never presumed to suggest that I considered myself to be an expert. Clearly, I'm not. But, at the same time, I felt that the report of the Inspector General's record made it appear as if I was a complete ignoramous. And——

Senator **Shelby**. Was his report right?

Mr. **Shelby**. No, sir. From that standpoint, I certainly don't believe that it was. That was the point I was trying to make.

Senator **Shelby**. Sir, how much money in your judgment, and you might not have the figures with you, how much money or fees—whatever you want to call them, consulting fees—have you generated beginning in 1985 from your consulting work in HUD?

Mr. **Shelby**. Probably, collectively, probably $700,000.

Senator **Shelby**. Could it be more?

Mr. **Shelby**. It could be, but I don't think it would be much more.

Senator **Shelby**. Would you make those figures available for the committee for the record? Could you do that unless it would incriminate you?

Mr. **Shelby**. Senator, I certainly don't think—I do not think—I know it wouldn't incriminate me.

Senator **Shelby**. Let me ask you this. Have you furnished those kind of figures to the Inspector General?

Mr. **Shelby**. I feel that I've testified as forthrightly as I can.

Senator **Shelby**. I understand that, but have you furnished those figures to the Inspector General or anybody investigating this?

Mr. **Shelby**. Everything that he's asked for, yes, sir.

Senator **Shelby**. Has he asked for that?

Mr. **Shelby**. So far as it's related to the program that we're discussing here today.

Senator **Shelby**. But what about all HUD fees?

Mr. **Shelby**. No, sir.

Senator **Shelby**. So you say your judgment is that you collected about $700,000 in fees since 1985 as a private consultant from your HUD activities?

Mr. **Shelby**. Either, and again I want to make the distinction as I did earlier with Senator Riegle, the vast bulk of these have been earned by my company rather than by——

Senator **Shelby**. Who owns your company?

Mr. **Shelby**. I am not an interest-holder in the company. I'm not a principal of the company. I have no vested interest in it.

Senator **Shelby**. So you're paid a fee then?

Mr. **Shelby**. Yes, sir.

Senator **Shelby**. In other words, you're not a stockholder so they pay you a fee?

Mr. **Shelby**. Yes, sir.

Senator **Shelby**. Now the money we're talking about here, $700,000, I'm asking you is that the fees you earned?

Mr. **Shelby**. Directly?

Senator **Shelby**. Right. Or indirectly, or any way you've gotten it.

Mr. **Shelby**. No, sir.

The **Chairman**. Senator Shelby, maybe I can clarify this because we went through some of this earlier. And the essence of it is that while he was working for the Keefe Company, he earned these consulting fees and the consulting fees went to the company. He then received a salary from the company, but there are a couple of exceptions to that.

For example, there was the Maryland company.

Mr. **Shelby**. Two exceptions.

The **Chairman**. Was the Cleveland UDAG an exception?

Mr. **Shelby**. No, sir.

The **Chairman**. It was not. But there were two exceptions where he did the deals and received part of the fee directly. So there's a mixture here, but we have asked for that information with respect to the Cleveland UDAG and any other activities with respect to HUD where he received a fee directly or indirectly, that those be listed.

If I recall correctly, you indicated you'd go back and generate that information for us.

Am I correct in thinking that I asked for that? I thought I did. If I didn't, let me now ask for it.

Mr. **Shelby**. Yes, you did. To the best of my ability, I will do so.

Senator **Shelby**. Mr. Shelby, have you worked other agencies other than HUD on behalf of clients as a consultant?

Mr. **Shelby**. Yes, sir.

Senator **Shelby**. Do you generate fees from this work?

Mr. **Shelby**. Yes, sir.

Senator **Shelby**. Are these fees similar in size to the ones you've enumerated here?

Mr. **Shelby**. No, sir. As I've indicated, again, a bit earlier, most of the fees associated with that work are of a more traditional nature. Those would be generally looked upon as lobbying type activities.

Senator **Shelby**. Mr. Chairman, I don't want to be repetitious here. And I was not in when you asked him the questions. So if you've asked this question, I'll scratch it off.

Did you get into the how he arrived at his fee, how many hours?

The **Chairman**. We went over that. But let me give you an essence of the response that we got. For example, in the Florida case, for which there was a $225,000 fee paid to the company, to the Keefe Company, he estimates that that involved three to four meetings with HUD officials, some dozens of phone calls to HUD personnel, particularly one individual. I believe I recall you said you talked to Debra Dean, and maybe one piece of correspondence that he's going to look for and see if he can find.

But that constitutes I think a fair summary of the description of the activity as it relates to HUD.

Mr. **Shelby**. As it relates to HUD, yes.

Senator **Shelby**. How many hours would that be just off the top of your head?

Mr. **Shelby**. Senator, I really can't say.

Senator **Shelby**. Would it be as much as 40 hours?

Mr. **SHELBY**. Clearly.

Senator **SHELBY**. Would it be as much as 80 hours? That would be 2 weeks work, regular work?

Mr. **SHELBY**. Senator, this occurred over a period of a year or more. It was considerable.

Senator **SHELBY**. Could you document in your best judgment 80 hours worth of work on this, more or less?

Mr. **SHELBY**. Senator, I just really can't say.

Senator **SHELBY**. Could it be less than 80 hours?

It could be, couldn't it?

Mr. **SHELBY**. Of course it could be, but I don't believe that it was.

Senator **SHELBY**. Will you furnish the number of hours the best you can construct for this?

Mr. **SHELBY**. Senator, that's what I'm trying to do now.

Senator **SHELBY**. But, if you had your records before you, you could do it better, could you not?

Mr. **SHELBY**. But, of course.

Senator **SHELBY**. You're just giving us your judgment, or you're saying you don't know, it could be so-and-so.

I'm trying to figure out about how much an hour you charge for this if you were dividing $250,000 by 80—let's assume it was 80 hours. You said it could have been less than 80 hours.

Mr. **SHELBY**. I also said I didn't believe that would be the case.

Senator **SHELBY**. Do you think it would be more?

Mr. **SHELBY**. Do you think it would be more?

Senator **SHELBY**. Could it be as many as 100 hours?

Mr. **SHELBY**. Senator, as I said, at this point in time, I just really can't.

Senator **SHELBY**. How can you justify your fee of that size is what I'm getting at. You're not a lawyer, are you, Mr. Shelby?

Mr. **SHELBY**. No, sir, I'm not.

Senator **SHELBY**. If you were a lawyer and you were billing out stuff as an ordinary consultant, wouldn't you bill out according to the time and effort that went into a situation as a rule? There might be some exceptions.

Mr. **SHELBY**. Yes, sir, but actually, with all due respect, I think if you're going to use the legal analogy, it would be more appropriate to draw the one to contingency fees that attorneys work for on occasion.

Senator **SHELBY**. Is that the kind of fee you have? Was it a contingency fee? It's your analogy now. You're drawing the analogy of a contingency fee. Did you in fact have a contingency fee on this?

In other words, if you delivered, you got paid the big balloon figure of $250,000, or whatever it was. If you didn't, you got zero for your time.

Is that what you had?

Mr. **SHELBY**. Not entirely. There was generally a retainer, but then the bulk of——

Senator **SHELBY**. How much was the retainer? Do you have a judgment?

Mr. **SHELBY**. In which?

Senator **SHELBY**. In the Florida case. The one that generated $250,000. What kind of retainer was that?

Mr. **Shelby**. I wasn't involved in a project that earned $250,000. The Florida project was $225,000.

Senator **Shelby**. That's close enough. That's a lot of money.

I'll take your figure, $225,000. I'm not arguing about that.

Mr. **Shelby**. Yes, sir. My recollection, and let me preface everything I say from this point forward by making the same point with you that I made right at the outset with Senator Riegle, that is, the fact that I only learned on Friday of last week of the committee's interest in hearing my testimony.

It was only yesterday that I was able to obtain those portions of the Inspector General's report that pertained to me. So I truly have had only the bare minimum amount of time to try to cover just those selected parts that have direct relevance to me.

Senator **Shelby**. Isn't this basically a situation of pure and unadulterated influence peddling? Isn't that about what it looks like even to you, a political consultant?

Mr. **Shelby**. No, sir, I would not characterize it as that.

Senator **Shelby**. What would you call it? A merit situation?

Mr. **Shelby**. Senator, I think it's important to know that in 1983 a real sea change, so to speak, occurred so far as the whole housing area is concerned.

I don't have to tell you that at that point in time, right or wrong, the Congress decided that it was appropriate to eliminate section 8 funding for new housing and for substantial rehabilitation and in doing so, it created an incredibly competitive environment for those relative small amounts of money that were then available for the housing programs.

And it was for that reason I think that you see developers engaging in a professional relationship with consultants to help them put their project, their respective projects, forward in the very best light possible.

It was incredibly competitive and obviously, if they had an opportunity to discuss the merits of their project with those people who were involved in the management of the program, it would enhance the likelihood that they might ultimately be successful.

I always felt that my job was to attempt to find a good developer that had a good project and a project that could provide housing in an area of demonstrated need.

And I believe that in those instances in which I was involved, that was the case.

Senator **Shelby**. My time is expired.

The **Chairman**. Thank you, Senator Shelby.

Senator Graham, then I'm going to try to finish with this witness so we can go to the next witness.

Senator **Graham**. Thank you, Mr. Chairman. Just to follow up on one line of Senator Shelby's questions, the Park Towers Project in Dade County, that's the one you received the $225,000 fee?

Mr. **Shelby**. Yes, sir.

Senator **Graham**. If you had been unsuccessful, if Park Towers had not received a HUD section 8 rehabilitation grant, under the agreement that you had entered, what would you be compensated?

Mr. **Shelby**. Senator, I honestly don't remember.

Senator **Graham**. Did you have a signed contract?

Mr. SHELBY. Yes, sir. I believe the fee would have been $5,000. But, again, I emphasize that that is based on the best of my recollection.

Senator GRAHAM. So the difference between being successful and being unsuccessful insofar as you were concerned was $220,000?

Mr. SHELBY. Yes, sir, that's correct. Again, I'm not trying to belabor this issue, but I think it's important that this was not an instance in which the fee came directly to me but rather came to my company.

Again, I would never suggest that I didn't inure benefit from that because, obviously, that was helping to pay my salary.

But, again, the impression that has been created is that there were just hundreds of thousands of dollars that were pouring into my personal coffers. And that simply was not the case.

Senator GRAHAM. Frankly, Mr. Shelby, I don't think it's an impression that's being created. I believe we're building the record here of one of the most abusive instances towards a Government program which has resulted in inordinate profit to those who are able to influence the system to the detriment of the lowest income people in our society depending on this program to give them some hope for a decent house.

I'd like to continue if I could.

Mr. SHELBY. Can I respond to that if I might? Because, again, I think that's an impression that has been created. Let me back up and start over.

NEWS ACCOUNTS INCORRECT

I believe that there is an impression that has been created by news accounts relating to the program that is incorrect. I think that many of the people who have read news articles that have related to the program assume that consultants have been paid with tax dollars when, in truth, that's obviously not the case at all.

Senator GRAHAM. I don't want to get off on that issue, but I think—did you hear the Inspector General testify about how the economics of these transactions were structured? And you don't think that that means that these were paid with tax dollars?

Mr. SHELBY. My point was I think the news accounts——

Senator GRAHAM. I'm not talking about news accounts. If you heard the Inspector General, do you have some different interpretation that these exorbitant fees were being paid with tax dollars?

Mr. SHELBY. I really can't comment.

Senator GRAHAM. Who do you think was paying them?

Mr. SHELBY. I was in the room. I was not really paying that close attention.

Senator GRAHAM. Well, I want to come back to my question. You stated that in this case the fee for failure was $5,000. The fee for success was $225,000. Was that ratio essentially the same in other contracts that you had for representation in Section 8 Rehabilitation Programs?

Mr. SHELBY. To the best of my recollection, yes, sir.

Senator GRAHAM. I want to talk about the program before and after 1984. Did you have any clients before 1984?

Mr. SHELBY. No, sir.

Senator **Graham**. So all of your experience was programs post-1984?

Mr. **Shelby**. Other than, as I mentioned earlier, during that period of time I was on the Senate staff, I did have some exposure to the program, acquired some knowledge relative to housing issues.

But, from the standpoint of business——

Senator **Graham**. In terms of having a contract with a client for purposes of representing them before HUD for a section 8 rehabilitation grant, all of your experience was post-1984?

Mr. **Shelby**. Yes, sir.

Senator **Graham**. What was your description of the decision-making process as you knew it to be post-1984? How did the HUD officials responsible for making these grants reach their decisions?

Mr. **Shelby**. There was a panel. At least my understanding was that there was a panel that was comprised of the Under-Secretary, the Assistant Secretary for Housing and the Executive Assistant to the Secretary that made recommendations to the Secretary relative to which projects should be funded.

Senator **Graham**. What were the criteria that that three-person used in making the recommendations?

Mr. **Shelby**. I think the principal criteria was demonstrable need.

Senator **Graham**. What were the other criteria?

Mr. **Shelby**. I think that everything flunked insignificance vis-a-vis that particular issue. Again, that's again only my understanding. I obviously never was involved in any of those meetings.

Senator **Graham**. You were the expert who got paid $225,000. You must have known something about how the system operated and what were the criteria and how do you go about building a case to meet those criteria, didn't you?

Mr. **Shelby**. Yes, sir.

Senator **Graham**. And you are saying that the only practical factor in their decision was demonstrable need?

Mr. **Shelby**. No, sir, I don't believe that's what I said.

Senator **Graham**. What were some of the other criteria in addition to demonstrable need?

Mr. **Shelby**. Of course, prior to I guess it was 1985, there was the fair share consideration, which the Congress waived.

Senator **Graham**. As I understand from our earlier testimony, fair share related to allocation of funds from Washington to the individual districts. Then each district had a process to review grant applications that originated from its particular geographic area of responsibility.

What I'm focusing in on is the post-1984 process of making determinations, and I'm asking the question:

In addition to demonstrated need, what were the other criteria that you as an expert in this system considered to be the relevant criteria that the decision-makers would take into account?

Mr. **Shelby**. Again, that would be far and away the most important, but in addition to that, obviously, a good, competent developer with a proven track record and a good project to work with, a good product to provide to those people who were in need of the housing.

Senator **Graham**. Going back to what you said was the overwhelming factor, the demonstrable need, how did you go about putting your client in the best position relative to demonstrating that demonstrable need? For instance, in the Dade County case, what did you present to the decisionmakers to indicate that Park Towers was at the top of the list in terms of demonstrable need?

Mr. **Shelby**. I talked about the need for low-income housing in that part of the community where it was located. Quite frankly, most of that information was provided to HUD Central by the local Miami office, who was interested in seeing it come to fruition.

Senator **Graham**. What was your contribution? If the overwhelming criterion was demonstrable need and information on that was supplied from the local HUD office, what did you contribute for $225,000?

Mr. **Shelby**. To the local?

Senator **Graham**. No, to the decisionmaking process.

Mr. **Shelby**. Again, and I don't mean to be redundant, I may be—perhaps I'm not following your line of reasoning here, but as I said earlier, I always felt that it was important to ensure that a client had an opportunity to present their project in the very best possible light, for them to put their best foot forward, so to speak, because in doing so, obviously, they were enhancing the likelihood of success. The more information that you could provide HUD officials about the merits of the project, the greater the likelihood that they might ultimately look favorably upon it.

Senator **Graham**. Mr. Chairman, I know that the time is getting to be short. I have more questions I might want to ask if we could reserve the opportunity to call this witness back. And I'd be particularly interested when that happens to talk about his experience with the UDAG program and whether he has encountered any similar circumstances there as the ones we had him describe here relative to section 8.

The **Chairman**. By all means. The witness has said that he was involved in one successful UDAG award grant in Cleveland, for which he earned a fee of several hundred thousand dollars.

So there was only one as I understand it.

But, nevertheless, he does have some experience in that area. I want to just ask one more thing and we're going to go to our next witnesses immediately.

That is, when did you get started in the business? You started in 1984, did you not?

Mr. **Shelby**. Well, really, for all practical purposes, 1985.

The **Chairman**. You started in 1985.

Mr. **Shelby**. December 1984/January 1985.

The **Chairman**. You're sure of that now?

Mr. **Shelby**. Yes sir.

The **Chairman**. The reason I ask is because the data that we have—you may be interested in this, Senator Graham—is that the Park Tower project was approved on July 16, 1984.

Mr. **Shelby**. Senator, I believe that's incorrect because it has to be 1985, because in 1984 I was not doing anything other than focusing on the reelection of President Ronald Reagan.

The **Chairman**. It's possible it's a typo. I'm taking it directly out of the Inspector General's report. He lists the date of the Park

Tower project as 7/16/84, 143 units. And then it goes down in a chronology listing thereafter three other 1984 projects.

But that's not to say it's accurate. I've had any number of documents given to me that aren't accurate. But, in terms of their report, their report identifies it at that date. We'll try to reconcile it.

Mr. SHELBY. Yes, sir, it's 1985.

The CHAIRMAN. In any event, I appreciate your testimony today. I will reserve the right to pursue this further with you. And I appreciate your coming forward today voluntarily and being forthcoming to the committee.

Mr. SHELBY. Yes, sir, thank you.

The CHAIRMAN. Let me now excuse this witness.

Judith Siegel and Fred Bush.

I'm going to indicate that we will not attempt to hear Mr. Melvin Adams today. I apologize to him for the fact that we're not going to get to the time where we can hear him today. I know he'll understand that. He comes from Kensington, Maryland, so I don't feel as if the geographic inconvenience is as severe as it might be with others.

Mr. Adams has agreed to appear at a later date, and I appreciate that.

I want to note that several public housing authority directors who were interviewed by the Inspector General refused to testify. They did so because they feared retaliation by the Department of Housing and Urban Development.

Therefore, I think it has taken some courage for him to come forward today, and he has nothing to fear because this committee will see to it that he has nothing to fear.

We will hear from him at a later date and that will be very important testimony.

Let me now ask you, Ms. Siegel and Mr. Bush, to both stand and raise your right hand, if you would.

[Witnesses sworn.]

The CHAIRMAN. Ms. Siegel, let us begin with you.

You may both have brief comments you want to make at the outset. If so, I'd like to give you the opportunity to do that. I'd like to keep that limited because I'd like to get into the questions.

I know the hour is late. Late for you; late for us. I appreciate your patience this morning.

Do you have an opening comment?

Very good. Let's hear it.

TESTIMONY OF JUDITH SIEGEL, PRESIDENT, LUNDEX CORP., WARWICK, RI, AND FRED BUSH, FORMER CONSULTANT, WASHINGTON, DC

Ms. SIEGEL. I do appreciate the opportunity to appear before you today.

I understand from my conversations with your staff that you would like me to provide you with information concerning Kingsley Park Apartments in Essex, Maryland, and my role as a developer, and James Watt's role in that project with me.

I am prepared to discuss that today.

As I told your staff, I have been eager to appear before both the House and Senate committees to offer my experience on the section 8 Mod Rehab Program and my comments on the Inspector General's Report.

Let me assure you that I am fully supportive of the Inspector General's audit and investigation to the extent that they will result in meaningful improvements in the program.

CHARACTER AND INTEGRITY QUESTIONED

I am, however, concerned about the report as to the impression it leaves of the character and integrity of many of the fine individuals active today in the rehabilitation of housing for low income persons. For it is these individuals who despite the dismantling of Federal programs for low income housing during the last 8 years have taken on the burden of providing housing for the nation's poor.

It is us who work every day, grappling with the problems of homelessness, the use of crack, broken families, the elderly poor and neighborhood crime.

I am also concerned that some of the information contained in the report is misleading and presented out of context. For example, relevant factual information about Kingsley Park which was made available to the Inspector General and would have cast a more complete picture of the facts was simply ignored and not acknowledged in the audit report.

The report does, however, accurately characterize the section 8 moderate rehabilitation selection process as being headquarters driven. I am not here to defend that process.

Quite to the contrary. That system left much to be desired. I had no control over the establishment of the administrative procedures. Congress and the administration had that power. But it is in that context that I want to discuss the much publicized involvement of James Watt in the Kingsley Park Project.

Contrary to what the Inspector General would like Congress and the public to believe, Mr. Watt did not receive a consulting fee for merely making a few phone calls. This is an example of information which the Inspector General has distorted and taken out of context.

Let me give you the facts.

After leaving the Interior Department in 1983, Mr. Watt, who is also an attorney, stayed in Washington and pursued a multi-faceted career which included working in the area of Government relations. In early 1986, almost 3 years after Mr. Watt left Government service, never—as a HUD employee, I moved my office into Mr. Watt's offices.

We agreed to work as joint venture partners on various prospective real estate endeavors. In addition to being an attorney, Mr. Watt had many contacts throughout the country and he knew and understood the Federal bureaucracy.

I, on the other hand, was very well versed in the specifics of HUD programs. Mr. Watt, then and now, never professed to be an expert in the intricacies of Government-assisted housing programs. I had that knowledge.

But, most people would agree, regardless of whether or not one shares his political points of view or cares for his personality, that he has a wealth of valuable experience in knowing how to move the Federal bureaucracy, and then, as now, it certainly needed to be moved.

As part of our agreement Mr. Watt was to pay certain overhead expenses, such as office rent, secretary, and so forth. I, in turn, would consult to his clients and he would assist, as necessary, on my projects.

On any project that we jointly ventured we would have a fee-sharing arrangement. From my activities, I had been aware of the 312-unit project in Essex, Maryland that met all of the basic requirements for the State's section 8 Moderate Rehabilitation Program and was already in the State's pipeline.

In other words, 2 years earlier, in response to a notice of funding availability, the State had selected this project when it was submitted by another developer. However, at that time, the State of Maryland did not receive an award of section 8 moderate rehabilitation funds.

The project was for sale and it was in disrepair.

Built in the 1940's and still structurally sound, its basic systems and components were in danger of failing. It needed, among other things, new roofs, windows and entry systems. The electrical service had to be up-graded and certain plumbing lines required repair or replacement.

The State and county desperately wanted this 312-unit resource to be preserved. Undoubtedly, unless significant investments were made, the project would continue to deteriorate. In fact, it was only because of the willingness of the State and county to use their own funds totaling almost $1 million to augment the Federal investment that all the pieces began to fit together.

Having been interested in the project, I discussed it at length with Mr. Watt. We analyzed its potential and considered the pros and cons. I gathered additional information concerning the need for the housing. There were approximately 4,000 people on the Baltimore County waiting list.

I evaluated its physical condition. I estimated the cost of rehab and the extent of the local and State support.

Once fully satisfied with the merits of this project, I assembled a well-rounded team of professionals to tackle this development.

Senator GRAHAM [presiding]. Ms. Siegel, I am sorry, but could you wrap it up in about a minute. We have a copy of your printed text. If you could summarize so we can have time for questions.

Ms. SIEGEL. Senator Graham, when I was called, if I may say, to the committee I told them that I was occupied and had something else to do. The committee assured me, the person who called me assured me that I would be given some time to make a statement.

Everybody before me has given a statement. It's very important to me. I've traveled far. And I would very much like to present it. It's very important to me.

Senator GRAHAM. We appreciate that. The normal rule is 5 minutes for opening statements. The red light is on.

We want to hear from Mr. Bush and then have time for questions. And we're going to have to adjourn at approximately 2 o'clock. That's our time constraint.

You could summarize as tersely as possible, realizing that your full text will be in the record and we have all had an opportunity to read it.

Ms. **Siegel**. I hope everybody does read it.

The two points that I want to underscore, then, are, first, that the fees paid to Mr. Watt for his participation on the team were not paid with any Federal, State or local funds, nor were they tied to the property, the mortgage or the rents in any way.

FEES PAID BY DEVELOPERS AND PRIVATE CAPITAL

They were paid solely out of the developers pocket and private capital. And that is a very important point that I must underscore here.

Finally, I want to say one thing with respect to a personal statement on this matter. Forgetting the fact that even though the Inspector General's report acknowledges that there was no wrong doing or violation of ethical statutes, I personally believe that it would be morally and ethically wrong to ask for Mr. Watt's support for a project that was not meritorious.

But, it is indisputably clear that the Kingsley Park Project was exemplary. I have brought with me, to enter into the record, today photographs of the project, both before and after rehabilitation.

In addition, I had planned to read into the record a letter of support that was written on behalf of this project to Secretary Pierce from Governor Shaefer of Maryland talking about the need for this project and how much they wanted a subsidy for this project.

Senator **Graham**. Without objection, the letter will be printed in full in the record.

[The complete prepared statement of Ms. Siegel follows:]

Statement of Judith S. Siegel
Before the Senate Committee on Banking, Housing
and Urban Affairs
Date: May 17, 1989

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to appear before you today. I understand from my conversations with your staff that you would like me to provide you with information concerning Kingsley Park Apartments in Essex, Maryland. As I told your staff, I have been eager to appear before both House and Senate Committees to offer my experience and perspective on the Section 8 Moderate Rehabilitation Program and my comments on the Inspector General's reports.

Let me assure you that I am fully supportive of the Inspector General's audit and investigation to the extent that they will result in meaningful improvements in the Program. I am, however, concerned about the report as to the impression it leaves of the character and integrity of the many fine individuals active today in the rehabilitation of housing for low income persons. For it is these individuals who, despite the dismantling of federal programs for low income housing during the last eight years, have taken on the burden of providing housing for the nation's poor. It is us who work everyday grappling with the problems of homelessness, the use of crack, broken families, the elderly poor and neighborhood crime.

I am also concerned that some of the information contained in the report is misleading and presented out of context. For example, relevant, factual information about Kingsley Park which was made available to the Inspector General and would have cast a more complete picture of the facts was simply ignored and not even acknowledged in the Audit Report.

The Report does, however, accurately characterize the Section 8 Moderate Rehabilitation selection process as being "Headquarters driven". I am not here to defend that process; quite to the contrary, Mr. Chairman, that system left much to be desired. I had no control over the establishment of the administrative procedures. Congress and the Administration had that power. But it is in that context that I want to discuss the much publicized involvement of James Watt in the Kingsley Park project.

Regarding Mr. Watt's involvement:

Contrary to what the Inspector General would like Congress and the public to believe, Mr. Watt did not receive a consulting fee for merely making a few phone calls. This is an example of information which the Inspector General has distorted and taken out of context.

Let me give you the facts:

After leaving the Interior Department in 1983, Jim Watt, who is also an attorney, stayed in Washington and pursued a multifaceted career which included working in the area of government relations. In early 1986, almost three years after Mr. Watt left government service, I moved my office into Mr. Watt's offices. We agreed to work as joint venture partners on various prospective real estate endeavors. In addition to being an attorney, Mr. Watt had many contacts throughout the country and he knew and understood the federal bureaucracy. I, on the other hand, was very well versed in the specifics of HUD programs. Mr. Watt then, and now, never professed to be an expert in the intracacies of government-assisted housing programs. I had that knowledge. But most people would agree, regardless of whether or not one shares his political points of view, or cares for his personality, that he has a wealth of valuable experience in knowing how to move the federal bureaucracy and then, as now, it certainly needed to be moved.

As part of our agreement, Mr. Watt was to pay certain overhead expenses such as office rent, secretary, etc... I, in turn, would consult to his clients and he would assist as necessary on my projects. On any project that we jointly participated, we would have a fee sharing arrangement.

From my activities, I had been aware of the 312 unit project in Essex, Maryland that met all of the basic requirements for the Section 8 Moderate Rehabilitation Program and was already in the State's pipeline. In other words, two years earlier, in response to a Notice of Funding Availability ("NOFA") the State had selected this project when it was submitted by another developer. However, at that time, the State of Maryland did not receive an award of Section 8 Moderate Rehabilitation funds.

The project was for sale -- and it was in disrepair. Built in the 1940's and still structurally sound, its basic systems and components were in danger of failing; it needed, among other things, new roofs, windows and entry systems; the electrical service had to be upgraded and certain plumbing lines required repair or replacement. The State and County desperately wanted this 312-unit resource to be preserved. Undoubtedly, unless significant investments were made, the project would continue to deteriorate. In fact, it was only because of the willingness of the State and County to use their own funds totalling almost $1,000,000. to augment the Federal investment, that all of the necessary pieces began to fit together.

Having been interested in the project, I discussed it at length with Mr. Watt. We analyzed its potential and considered the pros and cons. I gathered additional information concerning the need for the housing -- there were approximately 4,000 people on the Baltimore County waiting list. I evaluated its physical condition, the estimated costs of rehab and the extent of the local and state support.

Once fully satisfied with the merits of this project, I assembled a well rounded team of professionals to tackle this development. Mr. Watt became a member of that team. His role was in the area of government relations, mainly to move and unsnarl the federal bureaucracy, not just to help get Section 8 funds for this project. It was understood from the beginning that although part of the team, Mr. Watt would not be a partner. His responsibilities were to serve as a liason with the federal bureaucracy, having direct contact when necessary, and providing advice and counsel on all such issues. Any remuneration would be contingent upon the successful completion of this project and not merely on the award of Section 8 units. If the project received a Section 8 award, but never came to fruition, he would receive no compensation. His fee was analogous to that of an attorney working on a contingency; if the total project succeeded, he got a fee; if not, his overhead would not be reimbursed and his labor would go unrewarded.

In the fall of 1986, the Maryland Community Development Administration received an allocation of Section 8 funds which they awarded to the Kingsley Park project in their pipeline (then known as Burkleigh). Between the time this award was made and the time we went to initial endorsement of the construction loan, 12 months elapsed. During that time we encountered a myraid of issues that needed to be resolved; the tax laws changed; there were conflicts between the Handbook requirements for Section 8 Moderate Rehabilitation and Coinsurance; and by the time we got to closing, the general partners of Kingsley Park Associates had more than $500,000. at risk. If the project didn't close, the general partners would have lost it all.

Finally, after much hard work and several scars, the project did close in September of 1987. Mr. Watt received a fee which was equal to 2 1/2% of the total development costs of $13,000,000. I would like to note at this point that while I was not present at the hearings of Chairman Gonzalez's House Subcommittee on Housing, I have been told that in response to a question concerning the relationship between Mr. Watt's fee and the total costs of development for

Kingsley Park, the Inspector General responded that the total project costs were somewhere in the neighborhood of $2,000,000. While Mr. Adams stated that he would have to check the accuracy of that statement, those in attendance at the hearing were left with the impression that the total development costs were only $2,000,000. Mr. Chairman, I want the record to be clear. The total development costs for Kingsley Park were approximately $13,000,000. In this case, the size and the risk of the project clearly are significant. It is very damaging to our project and our reputation to have such misleading information being circulated in a public forum.

Let me underscore two very important points in discussing Jim Watt and his relationship to Kingsley Park.

1. As noted before, the fees paid to Mr. Watt for his participation on the team were not paid with any federal, state, or local funds, nor were they tied to the property, the mortgage or the rents in any way. They were paid solely out of the developer's pocket and private capital. Therefore, neither the subsidy paid by the government nor the mortgage insured by the government, or the rents paid by tenants were affected or increased by Mr. Watt's fees.

2. Ironically, the fees that are paid to consultants who can move the bureaucracy may, in fact, save the government money. In the business of development, time is money. Delays result in increased costs of construction, carrying charges, interest, etc. I'm sure it comes as no surprise to the Committee that the government moves like a snail--it can take four weeks to get a phone call returned, if ever. If a consultant can make the bureaucracy respond and save carrying costs, interest expenses or avoid increased construction costs, he/she is worth every penny of the fee. Having Mr. Watt on my team was like having an insurance policy; if I needed to unsnarl the bureaucracy, he would be the best person to do it. If I needed advice and counsel on strategies to keep the process moving, he could provide it.

The Inspector General himself has admitted to the confusing and contradictory rules and regulations of this program which had the potential for excessive delays. I assembled a team that could mitigate these delays.

I would like to conclude with one final personal statement on this matter. Forgetting the fact that even though the Inspector General's Report acknowledges that there was no wrong doing or violation of ethical statutes, I, personally, believe that it would be morally and ethically wrong to ask for Mr. Watt's support for a project that was not meritorious. But it is indisputably clear that the Kingsley Park project was exemplary.

Senator **Graham**. Thank you, Ms. Siegel.

Mr. Bush?

Mr. **Bush**. Thank you, Mr. Chairman. I have no prepared statement.

I would like to correct the record. The Inspector General, in his statement, stated that I received $260,000. That's incorrect. My company received $195,000.

Senator **Graham**. Does that complete it?

Mr. **Bush**. Yes.

EXPERIENCE AS A DEVELOPER

Senator **Graham**. Ms. Siegel, could you describe for us your previous experience as a developer or redeveloper, particularly of housing for low income families?

Ms. **Siegel**. I have been involved in the low income housing industry now—my first project was started in 1981, when I rehabilitated a small project in Paddington, Rhode Island. At the time I was amazed at the amount of red tape, the time that it took me to get that project processed.

In 1983, after having been in the public sector, never as a HUD employee and never as a Government employee, but rather as an elementary school teacher, a school psychologist, a consultant in the area of civil rights legislation, I started Lundex Corporation and became involved in the development of housing.

I have, Senator, become an expert in this field. I am one of the most recognized persons in the low income housing industry. I've been invited to speak at the National State Council of Housing Agencies and the National Association of Home Builders, the National Leased Housing and many other organizations.

I've been asked to testify before Congressman Rangel's Committee on the extension of the low income housing tax credit.

I educated myself in this field and have become expert in HUD and HUD programs. In addition, I am very, very proud of the housing that I have developed and very proud, and I think the tenants that live in the housing that I own and manage are very happy there.

I welcome anyone on the committee or your staff to please visit the housing that we have developed.

Senator **Graham**. With your experience in HUD, what is your assessment——

Ms. **Siegel**. Excuse me, my experience was not in HUD. In the housing industry.

Senator **Graham**. Working in the housing industry with HUD-assisted programs, what is your description of the criteria which are looked to by the HUD three-person panel in determining which section 8 rehab projects to accept and fund?

Ms. **Siegel**. HUD, there are five criteria that HUD should be looking for.

Senator **Graham**. Is this a should or is what they're looking for?

Ms. **Siegel**. Without the regulations in front of me, let me tell you what I know.

I started my testimony by telling you that I cannot defend the HUD selection process. I cannot defend what is going on at HUD. The agency is in disarray.

I only know that I, by reading the regulations, working closely with local and State agencies and developing public-private partnerships, have been able to develop housing despite the disarray of the agency.

Senator GRAHAM. I'm trying to get to another question.

Ms. SIEGEL. Let me tell you what I think.

There are five criteria that they should be—I don't know if they are—that they should be looking at.

Senator GRAHAM. If you don't now what they are, I'd like to go on to the next question.

Ms. SIEGEL. I know some of them.

Senator GRAHAM. What I'd like to know is you're the expert in how HUD administers this program. Tell me, what are the factors that HUD uses in making the judgment? They've got 100 applicants. They only have enough money to fund ten.

How do they decide which ten out of the 100 to fund?

Ms. SIEGEL. They should be looking at five criteria.

Senator GRAHAM. I don't want to be——

Ms. SIEGEL. Are you asking me whether I think that political influence is being used?

Senator GRAHAM. That's correct.

Ms. SIEGEL. Then let's ask that question.

Senator GRAHAM. I was coming to that. I was trying to get there with somewhat greater intelligence.

Ms. SIEGEL. Why don't you just ask me that question?

SYSTEM IS HEADQUARTERS DRIVEN

It's very clear to me, and I said in my statement, that the system is headquarters driven. There is absolutely no question about it.

Senator GRAHAM. Is that a euphemism for politically driven?

Ms. SIEGEL. That's the statement that was made in the Inspector General's Report.

Senator GRAHAM. Do you define that—is that a euphemism? Headquarters driven means it's politically driven?

Ms. SIEGEL. I don't know whether it's politically driven or not. I can't tell you here that that's how it's done.

I will tell you that there are clearly more applications than can be funded. That an application has to be very strong. It does have to be a meritorious application, and then, it is my opinion, if it has an advocate, that if you get HUD's attention it will have greater likelihood of being funded than if it didn't have an advocate.

Senator GRAHAM. Does having an advocate or having an advocate selected from a particular pool of people make a difference?

Ms. SIEGEL. Say that again.

Senator GRAHAM. You said it's important to have an advocate. Does that mean that you could pick out anyone who happens to be persuasive or you pick out someone who is persuasive, plus has a pattern of personal or political relationships?

Ms. SIEGEL. If you're asking me what my relationship was with Mr. Watt——

Senator **GRAHAM**. No, just as a general comment as to who makes an effective advocate before HUD.

Ms. **SIEGEL**. I don't know because I'm not involved in that.

I was talking about my relationship with Mr. Watt. I can tell you why he was an effective advocate for me.

Senator **GRAHAM**. How about holding that answer, because that's the next line of questions I'd like to ask.

The light is on. I'd like to turn the questioning over to Senator Shelby.

Senator **SHELBY**. Thank you, Mr. Chairman.

Ms. Siegel, how long have you been associated in the consulting business with former Secretary Watt?

Ms. **SIEGEL**. Mr. Watt and I joined forces in early 1986 when I moved my offices into his offices.

Senator **SHELBY**. Are you an attorney yourself?

Ms. **SIEGEL**. No, I'm not.

Senator **SHELBY**. Your testimony is that you bring knowledge of these HUD programs.

Ms. **SIEGEL**. I'm a developer of low income housing.

Senator **SHELBY**. Yes, ma'am.

How many consulting deals were you involved in with former Secretary Watt?

Ms. **SIEGEL**. Senator, Mr. Watt and I were not involved per se, the two of us, in consulting deals. The project in Essex, Maryland, where I was the developer and was working out of his office, we were involved in another business.

This is the only deal that came to fruition.

Senator **SHELBY**. Did you work mainly with former Secretary Watt in dealing with HUD or did you work with him in dealing with other agencies?

Ms. **SIEGEL**. When we joined forces in early 1986 we had planned to get involved in other real estate endeavors. We started because I happen to have been interested in the project in Essex.

We started working together on the project in Essex. We looked at numerous other projects and we dug many dry holes. Nothing came to fruition.

Senator **SHELBY**. How many successful projects at HUD have you and former Secretary Watt had together?

Ms. **SIEGEL**. One.

Senator **SHELBY**. I'm sure you are aware that Secretary Pierce, who was the Secretary of HUD, and former Secretary Watt were fellow Cabinet members in the Reagan administration.

Ms. **SIEGEL**. Correct.

Senator **SHELBY**. When you say the HUD official are looking for so and so, weren't they basically waiting on that phone call from someone well connected, like Secretary Watt, and weren't you involved in business with Secretary Watt because he had the political contacts that he could tap by making a phone call, generating a fee of thousands of dollars?

Ms. **SIEGEL**. Senator, I started by saying two things. One is that my relationship with James Watt was as a business associate and what he brought to this association is that he could drive the Federal bureaucracy, and I agree that it had to be driven.

I also told you that I could not defend the selection process at HUD. It is a process in disarray, and what I did was, despite its disarray and despite what anybody wants to talk about what happened there, I continued to be able to develop low income housing.

I figured out how to use that system. You are absolutely right. The process is unclear. It appeared to be discretionary. Nobody really knew how projects were selected, and despite that, by teaming up with someone like James Watt, I was able to drive that Federal bureaucracy.

I want to make something very clear. I didn't get to finish my statement. But, this is a very important point.

I teamed up with James Watt. He did not earn a fee for going to HUD, making a phone call and getting section 8 units. My agreement and my team worked together. If that project never came to fruition, if it never closed—and a million things could go wrong with these projects. They are very complicated—he would get nothing.

He understood that it was a contingent involvement, and the project had to close. He could have gotten the section 8 units.

Senator SHELBY. Let me ask you this. On the fee, how big a fee was involved in this?

Ms. SIEGEL. $300,000.

Senator SHELBY. How many hours did former Secretary Watt contribute to this?

Ms. SIEGEL. This was not something that you measure in hours.

Senator SHELBY. Do you measure your working hours?

Ms. SIEGEL. No, I do not.

Senator SHELBY. Would your judgment be that you spent over 100 hours on this project?

Ms. SIEGEL. This project was a $13 million project.

Senator SHELBY. I know that. I'm talking about hours now.

Ms. SIEGEL. Hours aren't relevant. We have to talk about risk.

Senator SHELBY. What was your risk, then? That was your word.

Ms. SIEGEL. I'm glad that you asked that question.

This project, as I told you, was a $13 million project. I was one of three general partners. When we went to closing on this project in September 1987, we had $500,000, approximately $500,000 at risk.

If the project didn't close then we would not have gotten it. We would have lost that money.

Senator SHELBY. What risk did former Secretary Watt have in it? Absolutely nothing, did he?

Ms. SIEGEL. He had no dollars in that.

May I continue?

Senator SHELBY. What would you estimate—let me ask this question.

What would your judgment be as to the number of hours former Secretary Watt had in this project?

Ms. SIEGEL. It would be impossible for me to say.

Senator SHELBY. Just your judgment.

Ms. SIEGEL. It's a question that really is irrelevant.

HOW WAS THE $300,000 DIVIDED?

Senator **Shelby**. No, it's very relevant. I think we can measure what kind of merit went into this fee billing here. In other words, is this just a rip off of the taxpayer directly, indirectly, trickling up, trickling down, if it goes there, or what?

How much money did you and former Secretary Watt split, $300,000?

Ms. **Siegel**. I have to explain, and I need the time to explain, my role and his role.

I was the developer.

Senator **Shelby**. We understand that, ma'am. I'm not trying to pressure you. I'm just trying to get to the point.

How much money did you all split, $300,000?

Ms. **Siegel**. No, we did not split $300,000.

Senator **Shelby**. How did you do it?

Ms. **Siegel**. First of all, there are so many things that I'd like to say.

Senator **Shelby**. Go ahead.

Ms. **Siegel**. You're asking for very important information and asking information that I heard discussed here this morning by the Inspector General that was incredibly distorted. It was taken out of context and it showed not understanding the business.

Senator **Shelby**. Ma'am, I just asked you a question. If you and former Secretary Watt generated a fee of $300,000 how much was yours and how much was his?

Ms. **Siegel**. The entire fee was former Secretary Watt's.

Senator **Shelby**. Was his fee—in other words, former Secretary Watt made the $300,000 fee and you did all the work. Is that right? That's basically what you're saying?

Ms. **Siegel**. No. Please don't put words in my mouth.

You have to understand my role and his role.

Senator **Shelby**. His role was making a phone call to somebody that he was well connected with politically, and your role was to do all the paper work and forms. Is that right?

Ms. **Siegel**. That is not the case.

Senator **Shelby**. What is the case then? I don't know how you could point any other way.

Ms. **Siegel**. I'm sorry, but please let me explain.

As the development team, there are three general partners in the partnership.

Senator **Shelby**. We understand that, ma'am.

Ms. **Siegel**. Each of us put up money as money is needed.

Senator **Shelby**. Watt was not one of these three partners?

Ms. **Siegel**. He was not one of these three.

Senator **Shelby**. He's a consultant; you're a developer. He's a consultant?

Ms. **Siegel**. Correct.

Senator **Shelby**. So, the three of you paid him $300,000 to make a few phone calls?

Ms. **Siegel**. And I say that that is not what we paid him for.

Senator **Shelby**. What did you pay him for? Did you pay him for his political connections? Why else would you pay him $300,000, other than to make a sweetheart call to a political connection to get something approved that you, as a developer, thought had merit?

You know, you were one of three, but you couldn't get it done, but he could get it done. That's why you hired him, isn't it?

Ms. **Siegel**. Mr. Watt and I shared offices.

Senator **Shelby**. I understand all that, ma'am We understand the background.

Ms. **Siegel**. He paid the overhead.

Senator **Shelby**. We understand that. But that's irrelevant to this.

We want to know why you hired him?

Ms. **Siegel**. We didn't hire him. He was part of our team. We included him on the team.

Senator **Shelby**. But he's not one of the three developers, you just said. Correct me if I'm wrong.

Ms. **Siegel**. That's right.

Senator **Shelby**. How is he one of your team, then? Tell me that.

Ms. **Siegel**. He is a member of the team. Just what I told you.

Senator **Shelby**. What was his role? What were his duties that were assigned to him?

Ms. **Siegel**. He was to drive the Federal bureaucracy when we needed it driven.

Senator **Shelby**. That's your phrase. Now, drive the Federal bureaucracy when it needed to be driven, that really meant get this project approved. He did get it approved.

Ms. **Siegel**. This was a project with it's own merit, which was brought to the attention of the Secretary. It was funded. But you know, between the time——

Senator **Shelby**. And if it had merit, and it was strictly on merit, you wouldn't have needed former Secretary Watt?

Ms. **Siegel**. It had been in the pipeline for 3 years.

Senator **Shelby**. OK. You needed help.

Ms. **Siegel**. Exactly right.

Senator **Shelby**. And you said, how can I get help? The former Secretary is well connected politically and you hired him, paid him $300,000, he got the deal approved. Isn't that the bottom line?

Ms. **Siegel**. I don't agree.

Senator Shelby, my statement was important.

Senator **Shelby**. We've got your statement. As Senator Graham has said, ma'am, the statement is part of the record. You know, we have it. This will be made part of this Senate Hearing Record.

We understand your statement.

Ms. **Siegel**. But part of my answer—I would like to read you part of the letter from Governor Shaefer.

Senator **Shelby**. Well, what does Governor Shaefer have to do with this? He can speak for himself.

I believe my time has expired.

Senator **Graham**. You see, that letter is part of the record and it will be available.

Senator **Shelby**. Thank you for your indulgence. Thank you.

Senator **Graham**. Mr. Bush, I don't want you to feel as if you're being ignored. [Laughter.]

How many clients have you had, or your firm, interested in securing section 8 rehabilitation grants?

Mr. **Bush**. I believe, three.

FINANCIAL RELATIONSHIP WITH CLIENTS

Senator **Graham**. What has been the outline of your financial relationship with those three clients?

Mr. **Bush**. I should add that two of those have been successful, and one was not.

The first one, and the one that is in the report, which was the Inspector General's Report, was with the developer in Bayamon, Puerto Rico who came to a former partner of mine and asked for some help in presenting a project on behalf of the Mayor of Bayamon.

This was the second half of the project. The first half had been started in 1979. It was a 180-unit tower, and now, this was the second 180-units in the other tower.

The financial arrangement with that developer was that he would pay us $50,000 in up-front—as a retainer, and were we successful, he would pay us another—just a minute, let me think.

[Pause.]

Well, he would bring it up to $225,000 total.

Senator **Graham**. So, $50,000 was your base fee?

Mr. **Bush**. Correct.

Senator **Graham**. And then an additive for success would have made the total fee $225,000?

Mr. **Bush**. Correct.

Senator **Graham**. What was the second?

Mr. **Bush**. I'm sorry, that's not correct. I misspoke. To bring it up to $180,000.

Senator **Graham**. So, it was $50,000 to $180,000?

Mr. **Bush**. $50,000 as a retainer and the balance to $180,000.

Senator **Graham**. So, $135,000 was the portion of the fee that was based on being successful?

Mr. **Bush**. Correct.

Senator **Graham**. You said you had two other clients. What were your financial contracts with them?

Mr. **Bush**. The other client was not the city. It was a project in Ponce, Puerto Rico which was I think 32 or 33 units. The fee, I believe, was $50,000. The other has never come to fruition, so there was no money paid.

Senator **Graham**. So, the second project was a straight $50,000 whether you were successful or unsuccessful?

Mr. **Bush**. No. It was success only.

Senator **Graham**. So, you got zero if you were unsuccessful and $50,000 if you were successful?

Mr. **Bush**. I will preface that, Mr. Chairman, by saying that on the second and third project I had no personal involvement. No client of mine was involved.

I did not work on this project.

Senator **Graham**. The third project, do you know what the financial arrangement was?

Mr. **Bush**. No, I don't.

Senator GRAHAM. Ms. Siegel, in your testimony and you've stated it in answer to a question, that this project had been bogged down in the State bureaucracy.

Ms. SIEGEL. That is not what I said. May I correct it? OK.

This project had been what we call a pipeline project. That means that the State had submitted, or had published a notice of funding availability in 1984. And in response to that notice of funding availability another developer, who at that time was considering purchasing the property, responded to it and the project was selected.

Went into the pipeline, but the funds were never awarded from HUD.

Senator GRAHAM. So, in your testimony you say "however, at that time" and I think that time goes back to a date in 1985.

Ms. SIEGEL. Correct.

Yes, Senator Graham, when the project was first selected by the State—because that's how the projects get selected—at that time, HUD did—or the State did not get an award of funds.

Senator GRAHAM. So, in the process to which this project had previously been submitted and evaluated, it had been unsuccessful?

Ms. SIEGEL. Correct.

The project itself wasn't unsuccessful. The State did not receive an award of section 8 moderate rehabilitation funding.

The way funding works is it is not project specific. Funding does not come from headquarters to a specific project. Funding comes from headquarters to a public housing authority. The public housing authority must advertise and projects must compete at the local level for that funding.

This particular project had already been through the competition.

Senator GRAHAM. Let me ask this question.

In 1986, when the Maryland Community Development Administration received an allocation of section 8 funds, which were then awarded to Kingsley Park Project, could you describe the competition that went on before the Maryland Community Development Administration that led to Kingsley Park being selected as the project?

Ms. SIEGEL. Since the project had been selected in 1984, it was considered a pipeline project and it did not have to be readvertised.

Senator GRAHAM. So there was no competition at the State level in 1986?

Ms. SIEGEL. Because there does not need to be, and there is a HUD notice that speaks to that. It's notice H84-28, which speaks just to that issue.

Senator GRAHAM. Ms. Siegel, there's been some inference that the way the system has worked is that developers in conjunction with their consultants in Washington knew in advance that their project was going to be selected before the money was allocated to either a State agency or a local public housing authority.

Was that the circumstance with Kingsley Park?

Ms. SIEGEL. No. And I think what happens is that somebody may know that the units are going to go to a housing authority.

They never go from HUD to a specific project. They go from HUD to a housing authority. It is the housing authority that gives it to the project.

Senator GRAHAM. So, once the State of Maryland was able to get these funds, there was no assurance that the money would go to Kingsley Park?

Ms. SIEGEL. There was no assurance the money would go to Kingsley Park. However, since the award was clearly for 312 units, this was the project that was in that pipeline for 312 units, so they did award it to this project.

They could have, however, if it wasn't a priority. They certainly could have. They were not bound to give it to this project, and if they wanted to, they could have readvertised it.

There was no bind on the Community Development Administration to give those units that they received to what was then known as that Park.

Senator GRAHAM. Mr. Bush?

Mr. BUSH. May I make a correction?

I misstated in my last comment about the funding on the first project. My comment has received up to date $195,000—this is on the Los Aminas Project—and there is an outstanding balance due of $65,000 which has not been received.

That puts it in perspective.

Senator GRAHAM. So, the total that's either been paid or is in accounts payable is $260,000?

Mr. BUSH. Right.

Senator GRAHAM. And your base fee was $50,000?

Mr. BUSH. Correct.

Senator GRAHAM. So, the contingency fee was $210,000?

Mr. BUSH. Correct.

I should add that that project was not closed. It is still going on.

Senator GRAHAM. Senator Shelby, I apologize. I will turn the Chair over to you. Thank you very much.

Senator SHELBY [presiding]. Ms. Siegel, I believe you used the word compete a minute ago. Projects compete.

Ms. SIEGEL. Correct.

Senator SHELBY. Do you call this real competition when you've got discretionary money in HUD? That's obviously—obvious to me, and perhaps to some of my colleagues on both sides of the aisle here in the Senate, that it wasn't.

I guess I would have hated to have been someone in Montana or Alabama or New York competing against people like you and Mr. Bush and Mr. Watt and Mr. Shelby—the other Shelby—who were well-connected politically to this. It seems that these projects got approved.

A few phone calls, a few letters, a few meetings—I don't know about meetings—rather than something on the merits. And I understand the program is discretionary.

But I would have hated to have been a person that was turned down and then see all the fees that were coming out of this that had been revealed to the press and say, well, gosh, I had a great thing, but look what happens in Washington.

You know, it's political influence peddling of the highest degree, and that's basically what this is. And isn't that why you hired former Secretary Watt? I can't think of any other reason to hire him, other than political.

Ms. SIEGEL. Senator Shelby, I came here today because I had a lot to say to your committee.

Senator SHELBY. But I'd like you to answer my question.

Ms. SIEGEL. The problem is I feel that words are being put into my mouth.

I came here today—I have a lot to tell the committee.

I, like you, am concerned about the way HUD operates. I, like you, want to see the system be fair and competitive. I said in the beginning of my statement the selection system was a problem. It needs to be revised.

And I was happy to come and testify.

Senator SHELBY. The selective system stunk, didn't it, so you decided to stay in it and you would play the game knowing how it worked on the inside? So, you knew you had to have a political contact well connected to the Republican Party and to this administration, the past administration, to get this done, and that's why you hired Jim Watt.

Is that right? Is that fair?

Ms. SIEGEL. That is not a fair statement.

Senator SHELBY. It's not?

Ms. SIEGEL. What you're giving me are partial truths in that statement. There are some things about that statement——

Senator SHELBY. Isn't there a lot of truth in what I just said?

Ms. SIEGEL. I think you're mischaracterizing it and it's unfortunate, because I came here with a very clear presentation to talk to you about numbers. When I spoke to the staff they asked me to come at a very late notice. They told me you wanted to know about numbers; you wanted to have facts.

I spent a lot of time preparing.

Senator SHELBY. Do you believe that the selection process on these projects was fair and was done according to what was right or politically connected?

Ms. SIEGEL. I think that the selection process on this project was the same as it has been on every other project since 1984.

Senator SHELBY. And it's a terrible process, isn't it?

Ms. SIEGEL. I told you, I wasn't here to defend the process.

Senator SHELBY. You can't defend the process.

Ms. SIEGEL. I can't. I wouldn't. I think it should be changed. I told you that in my statement.

I don't disagree with that.

Senator SHELBY. Mr. Bush, do you agree with that? Do you believe the process needs to be changed, or do you want to get your project closed out first?

Mr. BUSH. Well, should it be closed out, Senator, and I don't know whether it will or not, the balance will not accrue to me in any way.

Senator SHELBY. You're talking about the amount of $65,000?

Mr. BUSH. Yes. Whether it should be changed or not, I wish I were, but I'm not an expert enough in HUD matters.

Senator SHELBY. What did you bring as far as a knowledge base to this project that you have? What did you bring?

Mr. BUSH. Me, personally?

Senator SHELBY. Yes.

Mr. BUSH. I did not bring very much, Senator.

Senator SHELBY. Not very much?

Had you ever worked with a HUD project before?

Mr. BUSH. No, sir.

Senator SHELBY. Had you ever invested in a HUD project?

Mr. BUSH. No, sir.

Senator SHELBY. Why did they hire you in this, other than political connections?

Mr. BUSH. They didn't just hire me.

Senator SHELBY. They hired your company. You're a principal in that, aren't you?

Mr. BUSH. In my company? We're individual.

Senator SHELBY. Who owns your company?

Mr. BUSH. There is no company any longer.

Senator SHELBY. Who owned it then?

Mr. BUSH. Myself and a partner.

Senator SHELBY. Who is your partner?

Mr. BUSH. My ex-partner, Michael Dohan.

Senator SHELBY. What did he bring to the table, the knowledge base?

Mr. BUSH. He brought 3 years—the housing situation in Puerto Rico. He lived there for 3 years and during that time he established a very good knowledge of the Federal programs.

Senator SHELBY. Did he seek you out to form a partnership on this?

Mr. BUSH. Yes, he did.

Senator SHELBY. Did he seek you out specifically to form a partnership and get this project approved?

Mr. BUSH. No.

Senator SHELBY. Why did he seek you out?

Mr. BUSH. He sought me out——

Senator SHELBY. You said, on your own you didn't bring much to the table.

Mr. BUSH. I'll be glad to answer the question.

He was living in Puerto Rico and I was living here. While he was there he had many people coming to him who needed someone in Washington who could introduce him to people, who could make appointments for them, who could often times speak English for them because they may not speak English.

Because of that, he referred people to me. He referred potential clients to me.

We decided that we should form a company and he was going to be moving back to this area at that time.

Senator SHELBY. Mr. Bush, what is your present employment status?

Mr. BUSH. I am self-employed.

Senator SHELBY. Are you an attorney?

Mr. BUSH. No, sir.

Senator SHELBY. What do you do? You're a consultant?

Mr. BUSH. Yes.

Senator SHELBY. Are you consulting with other agencies, other than HUD?

Mr. BUSH. No, sir.

Senator **Shelby**. What kind of consulting work are you doing?

Mr. **Bush**. I am presently working as a consultant to the Executive Search Council.

Senator **Shelby**. Have you been announced as a nominee to be the Ambassador to Luxembourg?

Mr. **Bush**. Yes, sir.

Senator **Shelby**. Have you had prior Governmental experience in foreign relations?

Mr. **Bush**. Yes, sir. In foreign relationship specifically, no. But I spent 2 years as the Deputy Chief of Staff to the former Vice President and 1 year as Assistant Secretary of Commerce for Tourism.

I also worked here in the United States Senate.

Senator **Shelby**. Who did you work for?

Mr. **Bush**. For former Senator Gordon Allott of Colorado.

Senator **Shelby**. Are you proud of this relevation on your fees for this contract for doing very little work and making such a big fee?

Mr. **Bush**. Well, I think you have to put this in context, Senator.

Senator **Shelby**. That's what we're doing. We're putting it in the context of did you earn this fee? Was it based on just a rip off of the taxpayers?

Mr. **Bush**. My company received this money.

Senator **Shelby**. But your company is you. Now, wait a minute. You just told us a minute ago that your company was you and your partner, or was.

Mr. **Bush**. You asked me who owned it. Those are the people who owned it, but we had other people who were working for us.

Senator **Shelby**. Employees, but they're not principals? They were not principals.

Mr. **Bush**. They were not owners of the company, correct, but they participated in the projects.

I, personally, have tried to figure out because I thought I might be asked how much money came in to my bank account, Fred Bush's bank account, out of this particular project.

My honest assessment is I received $12,000 a year for 4 years. So, about $48,000 is what I personally got out of this.

Now, I did put plenty of time in this.

Senator **Shelby**. Have you got those time records?

Mr. **Bush**. No, I don't.

Senator **Shelby**. Do you have them? Do you keep them?

Mr. **Bush**. We never kept time records. We're a small company.

Senator **Shelby**. Have you put in as many as 100 hours? That's a lot of hours.

Mr. **Bush**. No, I didn't put in 100. I put in, easily, 50 or 60 hours.

Senator **Shelby**. Fifty or 60 hours, and what was the total fee that you received thus far, your company?

Mr. **Bush**. The company received $195,000.

Senator **Shelby**. And you got $65,000 holding. Is that due at time of closing?

Mr. **Bush**. If this project ever comes to closing—that we put in—my company, people in my company put in hundreds of hours on this project.

Senator **Shelby**. Here you are, been nominated or will be nominated to represent this Country in Luxembourg, a high office, a very prestigious office. Do you believe that this is an example of public service or an example of where the taxpayers being ripped off?

Mr. BUSH. The taxpayer in this particular instance I don't believe has been ripped off.

Senator SHELBY. Why?

Mr. BUSH. Because it's the developer who paid us.

Senator SHELBY. But let's get down—who absorbs all this? Do you believe—and I know, Mr. Bush, you're a very intelligent man or you wouldn't have gone as far in life as you have, but I believe some other people were talking about the developer did this or private funds.

But when you get a multi-million dollar project, don't you know that that is basically absorbed within the project? It either trickles down or trickles up, or whatever you want to say. It's part and parcel of the deal.

Mr. BUSH. But remember, Senator, this is not actually come to fruition yet. So if it doesn't come to fruition, and it may not because the original developer no longer controls the options on this building, then it didn't come out of anybody's pocket except the developer and that was the risk that he decided to take.

Senator SHELBY. Are you ashamed that these fees came out to the sunlight thanks to the Inspector General?

Mr. BUSH. No, I'm not ashamed at all.

Senator SHELBY. And you're proud to defend this in public?

Mr. BUSH. I have nothing to hide. What I have to defend is exactly what we did.

Senator SHELBY. In your own words a few minutes ago you brought very little knowledge to the table. It's all political contacts, isn't it?

Mr. BUSH. No, sir.

Senator SHELBY. If it's not that, what is it? Tell us what it is if it's not that?

Mr. BUSH. I didn't have any political contacts. The first time we went to HUD I did not know one single individual who worked in that building. I had never set foot in that building.

Senator SHELBY. But you knew the people that did know them, didn't you? Aren't you basically, or have been, very active in the Republican Party and a big fundraiser?

Mr. BUSH. I got my first meeting at HUD the same way I got my first job right here in the Senate. I didn't know one soul.

I moved here as a graduate student. I picked up the phone. I called.

Senator SHELBY. Wait a minute. I understand all that.

But, do you believe that the average person in Montana or Texas or New York or anywhere else could have just picked up the phone or made a few calls and got that project approved like you got it approved?

Mr. BUSH. That's not how it happened.

As a former Government official——

Senator SHELBY. If it didn't happen this way——

Mr. BUSH. Every single phone call and every single meeting—if someone called me I didn't know and they wanted to meet with people and I was a Government official——

Senator **Shelby**. You didn't know they were making those kind of fees, did you?

I'm going to adjourn the hearing now. The Chairman is gone. We're gone. We appreciate your patience. We do have your statements.

Thank you. The hearing is concluded.

[Whereupon, at 2:15 p.m., the hearing was adjourned.]

ABUSES IN THE SECTION 8 MODERATE REHABILITATION PROGRAM

WEDNESDAY, AUGUST 2, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 9 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Bob Graham presiding.

Present: Senators Cranston, Sarbanes, Dixon, Sanford, Graham, Wirth, Garn, Heinz, D'Amato, Bond, Mack, Roth, and Pressler.

OPENING STATEMENT OF SENATOR GRAHAM

Senator **Graham**. I call the meeting to order.

Before we commence the hearing this morning, I would like to announce that, as members arrive, they'll be voting with the committee's clerk on the nomination of Dennis Kloske to be Undersecretary of Commerce for Export Administration, and C. Austin Fitts to be Assistant Secretary of Housing and Urban Development.

Members have been notified that the vote will remain open until 11 a.m. The results of the vote will be announced at the hearing conclusion.

Our hearing this morning will follow up on questions that arose during our hearing in May regarding the Housing and Urban Development inspector general's report on mismanagement in the Moderate Rehabilitation Program.

In May, it was obvious that large sums were diverted to consultants and political fixtures who had little or no background in housing. The developers' incentives to secure political influence for their projects were substantial.

It now appears that the abusers of the Mod Rehab Program were able to generate cash in at least three ways.

First, allocation of Mod Rehab units gave a developer a 15-year guaranteed stream of rents that were much higher than the rents that they otherwise could have received.

This short-term commitment of 15 years also provided an incentive to the developer to maximize the future value of the project after the HUD rental period ended.

Second, coinsuring lenders gave developers abnormally large loans to finance extensive rehabilitation. HUD employees essentially accepted the lender's estimate of the rent levels that HUD should pay.

Third, developers were able to get an allocation of low-income tax credits to make the projects even more lucrative. These tax credits were intended for rents to be lowered to a range that is affordable to low-income people.

Once the Mod Rehab Program had already made all units affordable to low income tenants, the use of the tax credits only served to enrich the developer.

Central questions have not yet been answered. How much more housing could have been built with Federal dollars going to bricks and mortar instead of spending millions on gate keepers who opened the doors at HUD?

Why would a developer be willing to pay such high fees to a consultant to get Mod Rehab units?

How much money was generated by these projects?

Where did it come from? Where did it go? Who got it?

These questions will be addressed by today's panel. We will hear from a nonprofit developer and a local public housing official. They will tell us how the Mod Rehab Program should have worked and how much housing should have been produced in the Mod Rehab Program if it was working efficiently.

We will hear from the General Accounting Office, the HUD inspector general and the Congressional Research Service. They will discuss the amount of public benefits received for projects and identify the financial incentives that were received by developers and consultants.

The GAO has developed a cash flow analysis and compiled appropriate financial data for eight selected projects which they will outline for us to examine the profits made by the developers.

The HUD inspector general originally found that certain developers were able to distort the program so that they could generate large profits through substantial rehabilitation on large projects.

The IG has now completed a review of all Mod Rehab awards that exceeded 25 units from 1984-88, and has updated his earlier testimony.

The Congressional Research Service has looked at the fair market rents. We have asked CRS to determine whether HUD had agreed to pay rents to owners of Mod Rehab projects that were abnormally high in comparison with actual market rates in the localities.

Our goal is to understand what went wrong in the eighties so that we can spend our limited resources in the next decade to build the most housing for our money.

Before we begin, I have a statement from Senator Dixon for the record.

[The prepared statement of Senator Dixon follows:]

Statement by Senator Alan J. Dixon

Senator Dixon. Mr. Chairman, I am pleased that this committee is investigating abuses in the section 8 Moderate Rehabilitation (Mod Rehab) Program. I am genuinely concerned about the blatant uneconomical use of our scarce Federal dollars which were intended for housing the poor.

Additionally, I am very concerned and disheartened as more abuses are revealed about the role of former HUD officials in the Mod Rehab Program.

This morning, I look forward to hearing followup testimony from HUD's Inspector General, and reports from others. The public needs to know the extent of abuses in the Mod Rehab Program, and how effective tax credits have been in producing additional low-income housing units.

Additionally, I look forward to hearing testimony regarding the Mod Rehab Program as it relates to fair market rents.

More importantly, Mr. Chairman, I look forward to hearing the recommendations that these witnesses will present as a means of correcting abuses in the Mod Rehab Program.

Thank you, Mr. Chairman.

Senator **GRAHAM**. We thank the witnesses for appearing before the committee today and look forward to their presentations.

Our first panel will include Mr. Donald Terner, president of BRIDGE Housing Corp. in San Francisco; and Ms. Judy Truett, chief of housing assistance division, Jacksonville, FL.

STATEMENT OF DONALD TERNER, PRESIDENT, BRIDGE HOUSING CORP., SAN FRANCISCO, CA

Mr. **TERNER**. Good morning, Senator. Thank you very much.

I'm Don Terner, president of BRIDGE Housing Corp. I was formerly director of housing and community development for the State of California. I was actually a little uncertain as to why I was asked to testify in terms of what I might contribute, since I had never used the Mod Rehab Program.

But, I hope that my testimony, particularly in leading off these hearings, where I believe you're going to hear some fairly unsavory testimony, I hope that I can sound somewhat of a positive note.

I really want to emphasize the point that I believe it is possible to produce, it's possible to produce well, it's possible to produce efficiently, it's possible to produce without cheating the Government or without harming the consumer or bilking the taxpayer.

And I think, if I can make two very simplified points, I'd like to just point to, No. 1, the growth of our company. Without resorting to some of these $300,000 phone calls and the rest; and, No 2, the incredible value that I do believe exists within the Federal Government, within the mechanism and within the machinery of HUD.

It's crucial, absolutely vital to millions of consumers across the country. And I want to certainly make a plea that the baby not be thrown out with the bath water.

I'd like to just start by recounting a little bit of the history and the characteristics of our company. Five years ago, we started out in the back room of a sublet insurance company in downtown San Francisco with two people, just really a gleam in the eye. And this May, I picked up Builder magazine, which is at your place, Mr. Chairman, to read that our company had become the 125th largest home builder in the country.

BUILDER 100

THE SECOND 100

COMPANIES TO WATCH

RANK	COMPANY	1988 STARTS	RANK	COMPANY	1988 STARTS
101	Kimmins Corporation	1,062	151	Crowell Industries	704
102	Case Edwards	1,056	152	Weingarten-Siegel	702
103	Evans Withycombe	1,040	153	The Baldwin Company	687
104	David Weekley	1,035	154	S&A Custom Built	68[illegible]
105	Coscan Development	1,026	155	John Wieland Homes	67[illegible]
106	Shelter Contractors	1,008	156	Covington Devel.	65[illegible]
106	Woodcrest Devel.	1,008	157	Insilco Corporation	650
108	Elliott Homes	1,001	158	Levitt Corporation	646
109	Glenfed Development	1,000	159	Bozzuto & Associates	632
110	The Buie Corporation	995	160	The Holly Corporation	627
111	Calif. Communities	969	161	Sunrise Company	625
112	Mahaffey Company	950	162	Leisure Technology	617
113	Village Builders	934	163	Inco Homes	605
114	Homestead Group	932	164	Landstar Homes	604
115	Arthur Rutenberg	931	164	Diversified Homes	604
116	Shea Homes	921	166	Lockwood Group	600
117	The Grupe Company	914	166	Oceanic Properties	600
118	Deluxe Homes of Pa.	907	168	The Woodlands Corp.	595
119	Flournoy Construction	904	169	Int'l Developers	577
120	Continental Financial	900	170	Emerald Homes	575
121	Del E. Webb	893	171	Dividend Devel.	574
122	Calton	891	172	The Engle Group	573
123	Fryling Construction	867	173	Kettler Brothers	563
123	The Mitchell Company	867	174	Roberts Properties	558
125	BRIDGE	859	175	Pasquinelli Const.	557
126	Gulfstream	850	176	Woodview Devel.	556
127	Paragon Homes	849	177	Richmarr Construction	554
128	Condiotti Enterprises	842	178	Fidelity General Contractors	550
129	Blosam Contractors	824	178	Iacobucci	550
130	Wallick Construction	823	180	RGC-RecreActions	544
131	Dunmore Homes	821	181	Coleman Companies	542
132	Bramalea	811	182	First Financial Group	533
133	Lindal Cedar Homes	810	183	Silver Companies	530
134	Brehm Communities	809	184	Orleans Construction	528
134	Winncrest Homes	809	185	Taylor Morley Simon	527
136	Polaran Homes of Pa.	800	186	D&S Development	524
137	Pacesetter Homes	797	187	James-Lewis	520
138	Patwil Homes	784	188	Hofmann Company	519
139	Gemcraft Homes	769	189	Milburn Investments	515
140	John M. Corcoran	760	190	Bush Development	513
141	Valencia Company	756	191	Cambridge Homes	509
142	The Milton Company	751	191	Ridgeway Devel.	509
143	Newhall Land & Farming	738	193	Kaplan Organization	506
144	Century Homes	733	194	Brindley Construction	500
145	Calibre Companies	732	194	Urban West	500
146	McBail Company	730	196	Amercon Corporation	499
146	Union Valley	730	197	McMillin Companies	494
148	United Devel. Mgt.	729	198	Michael Andrew	490
149	Long Signature Homes	717	199	Harshbarger Const.	489
149	Toll Brothers	717	200	Larwin Company	481

DROPPING OFF

Eighteen companies from the 1987 BUILDER 100 fell into the second 100 in 1988. The average drop in starts was 38 percent. One company, Kimmins Corporation, actually had a 9-percent increase in starts, but still fell off.

BIG WINNERS

For the first time, a nonprofit builder, BRIDGE Housing Corporation (#125), appeared in the survey. Also, Bozzuto & Associates (#159), a spin-off of the troubled Oxford Development Corporation (#25), entered the survey in its first year.

STACKING UP

These 100 builders combined started 71,000 units in 1988. That's about 6,000 fewer than the top 10 builders in the BUILDER 100.

WESTWARD HO

California was home to 35 companies in the second 100, one more than on the BUILDER 100. The other most popular headquarters states were Pennsylvania, Virginia, and Texas.

FAMILY AFFAIR

John Corcoran, president of John M. Corcoran and Company (#140), is the older brother of Joe Corcoran, CEO of The Corcoran Jennison Companies (#64).

Mr. **Terner**. We are a nonprofit, public benefit corporation, the only nonprofit ever to make the Builder Survey, which, of course, in our industry is equivalent to the Fortune 500, et cetera.

We're a very young company. We capitalized on a very modest amount of money, less than $5 million. Yet, we've done over $300 million with the development.

We serve only one market: the San Francisco Bay area, where, as most of the Builder 100's serve markets from coast to coast. We are very specialized in that we produce only for the consumer that is making a very low income.

In each of our deals we have no political connections. We don't operate with bribes or fixes, as you mentioned in your opening remarks. We don't make $300,000 phone calls, and we do make very limited and crucial use of the existing mechanisms, particularly the tax credit mechanisms.

We work essentially with tax credits by themselves.

The tone of these hearings really came to me this morning when I was setting up this photograph over here and collating the photographs you have in front of you. Someone walked up, looked over my shoulder and sort of chuckled in a snide way and said, "Oh, is that a HUD project waiting for the scandal, I presume, to pour out?"

These are not HUD projects, but these are projects that are aided by the Federal Government in a crucially important way. They are aided because the Federal Government allows valid and workable mechanisms in the area of assisting developers to finance projects—not the guaranteed cash flow, not that 15-year stream of income that comes from a unit that doesn't have to meet any market test whatever, but essential programs that help the developer finance.

DEBT/EQUITY FINANCING

And there are two kinds of financing, of course. There's debt and there's equity. And on the projects that I'll speak about in a moment, we have used these Federal mechanisms. We've used the Federal debt mechanism through tax-exempt revenue bonds.

And we've used the equity mechanism through the 1986 Tax Reform Act, the low-income housing tax credits. And with those mechanisms and those mechanisms alone, we've been able to produce rents in the projects that you see in front of you at essentially $390 a month for a one-bedroom.

And I'm not sure that in different parts of the country that sounds high or low, but in San Francisco, that is a great bargain. To give you a sense of the bargain, one of our recent projects, for example, we had 114 units available to the public. We had to conduct a lottery with 3,900 applicants who were qualified for those units.

So this is a very substantial market, below the market, aided by the Federal mechanisms that are in place.

And I think the worst thing that could happen from these hearings is that the scandals that are gripping HUD and that disgust me and anger me when I read about them every morning in the paper, cast a pall over all of the decent work, the hard work that's being done out there.

It is valid. It is legitimate. It is done without bilking anybody.

FLEXIBLE PROGRAMS

What I would like to see as the net result of these hearings is produce programs that are flexible, that do not go to that 15-year guaranteed cash flow but, in fact, go to a broad array of programs. Actually, the Cranston-D'Amato bill is a good example of flexible money that can be administered in a decentralized way, with incentives to the developer who leveraged the very small precious amounts of Federal resource, and convert that into a real benefit for the consumer.

I'll just conclude my testimony by pointing to these photographs on the right. This is Pacific Oaks in the city of Pacifica, CA, 104 units. It was built on vacant land that had been foreclosed by American Savings, a troubled S&L. It had been booted by three developers back to the S&L, who said of this property, in fact, that if it had lungs, it could bark because, in fact, the land seemed unable and impossible to develop.

We came in. We took the property to the voters. We got 104 units approved on here. We were able to turn to the consumer with tax-exempt financing and with tax credits. No Mod Rehab. No direct Federal subsidy programs. No categorical programs from HUD. This is not a HUD deal. In fact, this is a U.S. Treasury deal. And it was a deal for the American consumer who desperately needs housing.

As the second example, Magnolia Plaza in the city of south San Francisco, 125 units, the same rent levels, the same Federal mechanisms, the same quality of living. These are full amenity apartments—tile roofs, detailed stucco, dishwashers, disposals.

These are units that go to the consumer at the same price that a homeless shelter costs in many cities. You could put a cot on an armory floor and it will cost you $10-$15 a night. The rent in these units—this is permanent housing—is $13 a night, $390 a month.

This is what can be done.

I believe this is what should be done. And the great concern I have is that the scandals that you're uncovering and that are making all Americans sick as they look at the waste of money, this is the activity, this is the hard work that's behind it.

And my plea to you is not to throw this baby out with the bath water. It's definitely needed.

Senator **Graham**. Thank you very much Mr. Terner, We've been joined by my colleague, Senator Mack.

Mr. Terner, you indicate that your degree of governmental involvement has been limited to tax-free financing and low-income tax credits.

Is that right?

Mr. **Terner**. That's correct.

Senator **Graham**. Could you assess how much per unit those two forms of subsidy contribute to reducing the cost of housing?

Mr. **Terner**. Those two mechanisms, and it varies depending on what other kinds of leverage you can get, but in these developments, half the units are tax credit units and half of them are market rate units.

And the difference between the tax credit unit and the market rate unit is the difference between $575 a month for the market rate units and $390 a month for the tax credit unit.

And that differential is essentially the power and result of the tax credit. And that saving to the consumer in terms of medical care, et cetera, that is a crucial savings. And it's obviously very close to $200 a month.

And that's about a 40-percent reduction to the family due to the power of the tax credit.

Senator **Graham**. Are there any other forms of assistance that you received? Zoning waivers of land use restrictions, or other local government or State government control guides?

OTHER FORMS OF ASSISTANCE

Mr. **Terner**. Absolutely. I would be remiss not to give credit to local governments in granting all the approvals for this, and specifically in granting density bonuses. We have density concessions in each of these so that California real estate, which is very, very expensive, will not imply a very high land cost per unit.

By granting us density bonuses, we are allowed to put additional units on the property. The key for us is that, when we get that density bonus, we cost the bonus units out as having zero land cost.

And so the basis upon which rent is charged starts with a tremendous leap ahead of the other units.

You can do it another way, too. You can take a density bonus and say the land costs for all the units drops a little bit. We try to take the most dramatic interpretation of that density bonus and say there's a zero land cost underneath the bonus units and the price that we pay for the property to begin with still sits underneath all the market arrangements.

And that was the transaction that we made when we bought the property from the seller, and the density bonus which was granted by local government benefits exclusively and entirely the low-income residents.

Senator **Graham**. With these benefits, through tax assistance and local government assistance, what level of income family within the San Francisco Bay area are you able to reach?

Mr. **Terner**. We are reaching without direct programs the $12,000-$25,000 a year income family. For us, that's teachers, policemen, firemen, nurses, retail clerks, industrial workers, clerical workers, entry level professionals.

In fact, Senator, it's the backbone of the work force. It's the backbone of the Bay Area economy. Those are the prople in a very high-priced market such as the San Francisco market or, for example, the Washington, DC market.

Those are the people, the working men and women, who are the people who are getting hit hardest by the housing crunch, who are forced further and further to the periphery of metropolitan areas, who come in with very long commutes—an hour, sometimes 2 hours, clogging the freeways, polluting the air, creating demands for new freeway lanes, new highways, new bridges, new parking areas downtown. And it begins to create a spiral that is incredibly dysfunctional for our metropolitan area.

Those are the people who are priced out and those are the prople who directly benefit.

I could add this. We could lower that $12,000 a year family when we do have some access to Federal programs. In some cases, for example, there are section 8 existing certificates available in the Bay Area that are actually being returned to the Treasury because, in fact, people cannot find units that are low enough in price to qualify for using those certificates.

Whenever that happens, we always offer units available to absorb those certificates and, when we do, then we can get down to a family. I know of one woman, for example, in one of our buildings, a single, working mother with three children in a three-bedroom apartment that rents for $895 a month and she is paying $90 a month because, in fact, she has access to a section 8 existing certificate and we've taken her off the housing authority waiting list and put her into one of these mixed income apartments.

Senator **GRAHAM**. We've been joined now by Ms. Truett. If Senator Mack has any questions during the first round of Mr. Terner, I suggest that we go on to Ms. Truett and then we'll return to question both of them.

OPENING STATEMENT OF SENATOR MACK

Senator **MACK**. Thank you, Mr. Chairman.

Mr. Chairman, I, too, share your desire that we not get so caught up in the investigation that we throw out good incentives and good programs. We are going to be focusing on what individuls have done over this series of hearings. There's no question about that, and that's what we should be doing.

But I think it is appropriate that we point out that many of the problems we're going to end up dealing with, so much just what the individual did or what party might have been involved, but the reality that we designed programs that encouraged people to do exactly what was done.

You cannot set up $50 million in, quote, "discretionary funds," and not expect people to use some political influence in order to try to redirect where those resources are going.

So I think it's quite appropriate, what you said earlier, that we not destroy good programs and adequate incentive to get the kind of housing stock that is necessary for those individuals and families that so badly need it.

I was recently down in Melbourne, FL, touring one of the housing projects in Melbourne. This particular area is probably 25 to 30 years old, as I recall now, in terrible condition. In many cases, looking as if it had been in a war zone. But, yet, it was still families living in those units.

Their appeal to us is that we have got to find ways, No. 1, for them to be able to live in safety, not just from the units themselves but from the types of individuals that are occupying those units.

So there's a lot we need to do, and I think you're absolutely right to at least suggest to us that we ought to try to differentiate between those programs that, in fact, are working and those that are not.

I was particularly interested in the concept of the way you mix, or the makeup of the residents in your units with a market rental of $575, and then those who are assisted at $390.

I don't know how many other developers do that. I think that's a good approach. I wonder if you could just take me through, though, one of those particular transactions.

You mentioned, for example, that the property in which the first project was developed was purchased either from a failed S&L—the property had been attempted to be used several times and had been turned back on several occasions.

Then there was the density bonus. And, of course, the method of financing or incentive that you mentioned was the tax credit.

I wonder, I guess what I'm saying is:

Is this a very unusual deal? Was the ability to get the land below price? It sounds like there might have been more involved in this than just a Federal incentive to build it.

I wonder if you could address that for me.

Mr. TERNER. Certainly, Senator. There is more involved in each one of these transactions. Most real estate developers and business people, entrepreneurs, will tell you that there is no cookie-cutter deal when, in fact, you are not into the feeding trough, so to speak, the thing that you mentioned.

I'd be happy to mention the techniques in this project. This was foreclosed property. It was back in the portfolio of the failing S&L. It was American Savings who owned this property. They were willing to option it for a very low price because, in fact, this was not seen any longer as an asset, but a liability on their books.

We took advantage of that very low-priced offer figuring that the main thing that was impeding this property from actually being used was the fact that the local community's growth restrictions had discouraged developers who had option to the property before us and had booted it back to American Savings.

It discouraged them from going forward.

Senator MACK. When you say growth restrictions, are you talking about some kind of betterment fees?

Mr. TERNER. There were very substantial betterment fees. But, more importantly, there was a very small, limited number of units.

We understood that the opportunity here, the entrepreneurial opening, was to go back to the voters of that community, show them a well-designed, sound project that would be a good neighbor and an asset to their community, and seek voter approval for a development like this.

A private developer very often stays away from going back to the ballot box and asking for voter approval for a project.

We have the audacity, you might say, but also the drive and the motivation to go back to the voters. We made our case to the voters and the voters approved this in the November ballot by an 83 percent positive vote, including the precinct where this project was.

That gave us an ability to go forward. It gave us added density on the land. And coupled with the very low price that was being offered by American Savings, which was their book value.

So this failing S&L did get its book value, although the land had been written down because of the troubles that it had. But it got book value for that property.

Senator **Mack**. Let me just ask one question.

What would you estimate the value, both the number of units that you were able to get increased, and the decrease in the land value? What did that amount to per unit?

Mr. **Terner**. I would say that apartment properties in this community would be worth $20,000 to $25,000 in land costs per unit. When all was said and done and we had our voter approval and we had our density bonus and we had deferral of some of the city fees, we essentially went into this deal at about $5,000 per unit. So there was a big hit there.

We're already talking about essentially $20,000 and that translates directly into the first step of savings to the consumer.

Senator **Mack**. So roughly, from $15,000 or $20,000 down to $5,000?

Mr. **Terner**. That's correct, Senator.

Senator **Mack**. Very significant.

Mr. **Terner**. Once we put this together we used a tax-exempt bond. It was originally done by Wells Fargo Bank for us under the Community Reinvestment Act. So we had rather low origination costs, although no other particular break there.

We paint a point and a half to originate a tax-exempt lower floater for this property. From that point, we went forward and financed the deal, added tax credits on. We were one of the first tax credit deals in our region, and we sold those tax credits directly to Chevron, U.S.A.

Our company is big enough now that we don't need syndicators or intermediaries or brokers. We go directly to the buyer of tax credits. And, basically, they are corporate buyers. Chevron took a look at this. They liked not only this transaction, but they have bought other properties from us.

And they furthermore have said that they do up to $50 million worth of tax credit purchases from us.

All of this goes to show that there is an ability for private companies to make use of the tools that you have. They're anxious to do it. They are very powerful and they're very valuable, not only to Chevron but to BRIDGE Housing Corp.—my company, but most importantly to the community and the consumer.

Those are the mechanisms that we put together. And there are similar stories, although with variations.

Senator **Mack**. Let me just ask one more question, and then we'll go on. The $575 figure that you mentioned, is that the rental fee if there were no incentives at all?

In other words, if you just went out and bought that land under normal pricing conditions, received no density increase, unable to finance through the tax credit concept and not used tax-exempt bonds, is the rental fee approximately $575? Or is it actually higher than that?

Mr. **Terner**. That $575 has nothing to do with us or nothing to do with our costs. That $575 is any consumer on the street, you go down to another apartment complex or you come to ours, and that consumer is shopping for the best rent and the best value and has nothing to do with the cost of the development.

Senator **Mack**. So that's a truly market rate.

Mr. **Terner**. That's the market rate unit. And this is really crucial. The developments that don't meet a market test, that are only workable because there's a guaranteed cash flow from the Government, where you turn businessmen and women and entrepreneurs into administrators of Government subsidy programs, then you are going to get a feeding frenzy.

Then you are going to get these huge fees and these high-priced phone calls, because that's a deal on a golden platter. So, your earlier comments were right. That's the kind of thing that's going to spark somebody making a business decision to pay a James Watt $300 grand to make a phone call, because they're so fat and they're so lucrative, those units do not have to meet a market test.

DISCRETIONARY FUNDS

The other thing that I would hope I might ask you to consider, you were talking about discretionary funds. Discretionary funds aren't particularly a bad thing if the person who has the discretion maintains his or her public trust.

Discretionary funds can be very useful because they allow some of the flexibility that I think is one of the points that commends the Cranston-D'Amato bill.

It's not a discretion, per se, that's the sin here and that invites the abuse. I think that's good.

The fact is that it is a failure of the public trust to use that discretion which was designed by the Congress, I believe, and requested by HUD, I believe, because they do want to have an ability to fund some unusual things.

Development is continuously an exercise of cramming square pegs into round holes. And without discretion, you don't have any of the programs that fit.

So I hate to see discretion reduced; what we need is a higher standard of public trust and a higher standard of ethics in administering that discretionary money.

And the Cranston-D'Amato bill has an interesting incentive for Government to do that because it allows developers to come in with competitive projects, where the public can make evaluation of the highest amount of leverage and the highest amount of public benefit.

And it's essentially discretionary based on a public benefit test. That's something that I would applaud and it need not result in the kind of slime and corruption that I'm sure you're going to be uncovering and hearing about as these hearings proceed.

Senator **Mack**. Thank you.

Senator **Graham**. I might comment, and then a couple of more questions before we go to Ms. Truett.

Your last statement is exactly what a major focus of these hearings will be on. That is, to attempt to understand how that discretion was utilized and if it was applied against a standard of what is in the best public interest and, if not, why not. And if not, what we can do about it now in order to bring this program into the public interest channel that it was initially intended to be.

Let me ask two final questions.

One, what level of profit per unit, and I recognize you are a nonprofit developer, but can you comment both for yourselves and for a for profit entrepreneur?

What type of profit per unit on a project like this would be required in order to make it attractive for the entrepreneur to utilize the financing and design creativity that you've demonstrated here?

PROFIT MARGIN

Mr. **Terner**. I would say that a typical profit margin can be 5–10 percent per unit.

Senator **Graham**. Five to 10 percent of the completion?

Mr. **Terner**. Of the development costs.

What we do, and we do make a profit in that sense, we have a 5–10 percent margin on many of our units, on those $575 a month units. We have that margin.

The difference between us and any for profit developer is that we are structured, such as a tax exempt 501(C) corporation, to dedicate that profit back to the consumer.

So we'll add a number of below unit units with that margin. But that isn't the only way to go. I think the private sector has a very important role here. And I think, if the tax credits can be finetuned and tax-exempt financing can be preserved, that private developers will step forward and they can produce a lot more volume than we.

I think we're an exception. We're the only nonprofit corporation ever to make the Builder 100 survey. And by being the 125th largest home builder in the country, we have some exceptional status.

But there are no other nonprofit on that list, nor have there ever been any nonprofit on that list. So that you're really, if you care about the volume, you want to tailor this not to organizations such as my own—our company is somewhat the exception. You want to tailor it to the mainstream, for profit developer.

Let me make a fair, reasonable return and that's the guts of the American nation. Private enterprise will produce, and it will produce adequate numbers there.

Senator **Graham**. A final question relates to the tax credits that were available to you. In California, what is the process for allocating those tax credits? And were they readily available or were they highly competitive?

Mr. **Terner**. Senator, you really don't want to know the answer to that question. [Laughter.]

I'm ashamed to tell you, the process in California is a total, incoherent zoo, as far as I'm concerned. People go up to Sacramento. I'll tell you this.

I am hearing stories on the street of high-priced consultants, costly phone calls and all the rest being made now in California to do the tax credit allocation. We've run out of tax credits.

BRIDGE Housing Corp. has four of five projects cued up waiting for tax credits, projects ready to start construction.

I will tell you. Without going into detail, and I'd be happy to provide some additional testimony here, the tax credit allocation process is totally irrational. You are absolutely right to ask that question, and if the Federal Government can make some important reforms here and give the States some clear guidelines, you will be doing a great service to this process.

And the most important guideline is that there be a use it or lose it allocation. Don't have people lining up for tax credits, taking precious allocations away on a blue sky project that will never see the light of day. And you have projects ready to go into construction, ready to rent up that can't get tax credits because they fell in line behind some of these phony-baloney deals.

If the Federal Government can say to the State:

You've got these tax credits, they are very perishable. Allocate them to a developer. He's got 60 days to close or 90 days to close. And if he can't close in that period of time, he may seek an extension of another 60 days with cause, or something like that. And then, boom, it's Cinderella. You turn into a pumpkin and somebody else is ready to, gets that tax credit.

That's something we don't have in California. I don't believe very many States do. I've heard something about perhaps New York State has at least taken a step beyond California here. It's desperately needed, as are a number of other reforms in the tax credit world, one of which is that there's no limit to the basis on tax credit.

You have people seeking tax credits with a $200,000-$300,000 per unit basis cost. That's baloney.

The other thing that the Federal Government can do is cap with tax credits, so that maybe you max out at $100,000 a unit in basis costs. That will allow those tax credits to go much further and be spread much more widely, reach more consumers, and give the Federal Government and the U.S. Treasury a lot more housing for every credit dollar that's lost.

Senator **GRAHAM**. Thank you very much, Mr. Terner.

We will return for some additional questions after we have heard from Ms. Truett.

Senator Mack has an additional question. And before I turn to him, I will just say that, when we get to the second panel—and I hope that both of you will be able to stay and participate in that discussion—we're going to see how some tax credits were, in my judgment, misused by being layered on top of already very lucrative public subsidies that arguably had no beneficial effect in terms of producing housing for the people who were intended to be served.

Senator Mack.

Senator **MACK**. A $100,000 sounds like a pretty high figure. Can you relate that?

Mr. **TERNER**. I threw that out, Senator Mack. I think that would have to be looked at quite carefully. I will say this.

Most importantly, like every other Federal mandate that is crafted here in Washington, DC, it doesn't fit the country from coast to coast. And what we really have to do in looking for a Federal tax credit maximum is index according to costs in the different market areas.

So that, in one place, that max may be low as $40,000 or $50,000 and, in another place, it may be as high as $100,000 or $110,000.

But I will tell you this. Two and three hundred bases is off the chart. It's an absolute waste of the tax credit mechanism.

That means that two, three or four units that could be produced elsewhere with the same loss of revenue to the Treasury, and multiply three or four times in terms of benefit to the consumer, is being wasted in the program.

Senator **Mack**. Thank you.

Senator **Graham**. Our second participant on panel one is Ms. Judy Truett, chief of Housing Assistance Division, Jacksonville, FL. Ms. Truett.

STATEMENT OF JUDY TRUETT, CHIEF, HOUSING ASSISTANCE DIVISION, JACKSONVILLE, FL

Ms. **Truett**. Good morning, Senators. I am assuming that you do have my written statement, so I'd like to kind of save a little time rather than read the whole thing to you.

Senator **Graham**. That would be appreciated.

Ms. **Truett**. And go into what I consider some of the main points.

First, I would like to talk about some program successes on which Mr. Terner probably commented very adequately, but I'd like to give the comments of a local government official.

As well as preserving the housing stock, it addressed another very important national policy. And that's to ensure that rental housing is set aside for low-income families. Not just for now, but continuing at least for 15 years.

LOCAL LEVEL SELECTION OF PROJECTS

The program allows the local level selection of projects that are to be completed. We found that, at the local level, to be one of the most advantageous parts of it because it enabled the Public Housing Agency to address housing needs outlined in the Housing Assistance Plan then, with the Community Development Block Grant.

This may have been one of the most important aspects of the program as local communities regained some measure of local control regarding the placement of assisted rental housing for families.

Local placement allowed for much improved economic and social mix of its low-income population throughout the city. Further, local governments could better assure the low-income housing rehabilitation could be completed in areas of developing employment.

In other words, we could match the dollars with the resources as to wherever we needed to have housing for low-income population.

With review of the Housing Assistance Plan by the Department of Housing and Urban Development, local governments could be certain that low-income families would have increased access, not only to jobs, but also transportation, health care, shopping and, most importantly, to good schools for their children.

In the early eighties, the Mod Rehab Program allowed local governments that were interested in improving the local living conditions of the low income population to plan regularly for a dedicated source of funding for rehabilitation.

This program seems like a small but steady supply of improved housing that the housing planners could include in their communities assistance plans. Progress could then be made toward the national State and local goal of affordable rental housing for all communities.

In Jacksonville, nearly a thousand units of rental housing have been rehabilitated since 1981 under the Moderate Rehabilitation Program. Jacksonville has 40,000 substandard rental housing units; only 2.5 percent have been rehabilitated under this program in the last 2 years. The need is great, the resources small.

Those are some of what I consider to be the major successes. If you don't have private industry interested in doing this, I do not think that local governments have the resources and the abilities perhaps in the same measure that private industry does to be able to complete these kinds of needed projects for low income people.

SOME PROGRAM FAILURES

Next, I would like to go into a little bit of what we consider to be the program failures. Local government housing agencies apply to their respective U.S. Department of Housing and Urban Development field office for Mod Rehab allocations.

These allocations were based upon need demonstrated by local government's housing assistance plan, as mentioned above. Also, probably a comprehensive plan.

We have quite a good one in Florida that we are completing at the local level now.

During the first 2 years of the program, Mod Rehab units were, in fact, granted to public housing agencies based on local demonstrated need. Developers of large and small-scale rehabilitation projects were required to go through the PHA, or local government in order to apply for their rehabilitation for their properties.

PHA's would publicly advertise and market the availability of their Mod Rehab allocations through their request for proposals.

After applications were received, the PHA's would then rank and rate the applications made to them by developers, and select the ones best suited to meet the policies and the goals as set out in the local comp plan and the Housing Assistance plan.

Jacksonville's Mod Rehab administrative procedures, developed in 1980, have been revised several times over the years, but have consistently utilized the awarding of units to developers on a ranking and rating basis.

From 1982 on, local governments like Jacksonville no longer received yearly or biannual allocation of Mod Rehab units. Hence, your planning flow for providing the resource of low-income housing was very sporadic.

Upon our inquiry to our field office of U.S. HUD, Jacksonville was advised that Mod Rehab units were being distributed to the States by the central office. And I believe that a lot of this came about because local governments were not as sophisticated early on with the Mod Rehab units and there were a lot of problems in that area.

I do think that a lot of that has changed and could be changed in the future. Jacksonville didn't receive any more Mod Rehab units until 1983, when the PHA was approached by a developer from south Florida. The developer urged our department to apply for 80 units of Mod Rehab.

In a short time, the request was approved by U.S. HUD. The city initiated its administrative plan, advertised the units' availability and received only one application, which was from the south Florida developer.

The south Florida developer went into partnership with the local Mod Rehab developer, using financing approved from the Duval County Housing Finance Authority's tax exempt bond issues. From this point on the developer brought units were the only way Jacksonville received rehab units.

That kind of threw a little kink into our plans, but we were very, very happy to receive the units, the notice that units would be available to us. Because at our local level, we have a waiting list of some 3,800 people—that's as of right now—for assisted housing. So, again, the need is great.

The PHA is contacted by a developer. This is the usual case. Asked to apply to the field office, and to give the specific number of units and the specific bedroom size breakdown on the application to U.S. HUD, U.S. HUD's field office.

The field office then finds out from the central office that X-number of units are available for Jacksonville, and the process of local advertisement would take place again.

The city's PHA was approached by a number of developers indicating interest in seeking units for Jacksonville.

When it was explained to them that the city's plan involved competitive review and ranking of proposals, many developers didn't come back.

At the same time, the Mod Rehab allocation process changed, the U.S. Department of Housing and Urban Development's budget was decreased, and I think this is the second key failure, you might say, in the program.

This eliminated many positions in U.S. HUD's central regional and especially the field office. It also made it difficult for the regional and local offices of U.S. HUD to fully train its own staff, let alone to train PHA staff, in the use and implementation of the Mod Rehab program.

Into this training void came the larger, more sophisticated developers, bringing promises of very needed Mod Rehab units to the untrained staff of local public housing agencies.

Developers also offered to complete Mod Rehab applications and various calculations, processes, as well as to manage the PHA's paperwork for recertifying tenants once the rehab process was complete.

Some untrained public housing staff, agency staffs, were often not equipped to deny inflated rent structures and reject eligible developer fees that were built into project financing due to the lack of adequate training at the local level, the PHA level, and at the field office, compounding an already flawed system. Monitoring by U.S. HUD was sporadic.

This was probably due to field HUD personnel cuts at the field office level, and also the enormous burden of paperwork that was placed on those who remained.

There was little assistance given in the form of up to date manuals. I have a manual here that was one that we got that says August 1979. And, frankly, we have never had a really good update ever since.

Fortunately, we have a very fine staff that works very well with our local office at U.S. HUD, and we have not had problems in our administration of the Mod Rehab Program.

I think most of that is due to the fact that we have very good local staff who stay on top of it, and because we have a good ranking and rating procedure.

All of these events may have resulted in a concern regarding rental subsidies that the inspector general is now finding throughout many local PHA's.

Now, this is what I consider to be the most important part and why I came up to see you today. I'd like to give you what we considered to be some of the areas where we can correct the problems, at least from a local housing PHA perspective.

Awards of Mod Rehab units should be made to local field offices based on the local demonstrated need. That's the way it used to be. And very fair criteria should be used and well-publicized to PHA's in advance of notice of fund availability.

I think, certainly, consideration needs to be given to the fact that we have a very limited resource. And if we took, say, the 5,000 units, that's generally the budget for Mod Rehab, and spread it out over every PHA that we have in the country, which I think numbers between 2,000 and 3,000, you'd maybe get two Mod Rehab units.

That's not really enough to make a very good impact. So, at some point, I think consideration needs to be given to the allocation process, the unit number being enough to make a dent. Perhaps it could be done in the way the community development block grant is done with utilization of entitlement perhaps for large cities.

So these are the things we feel that are the most important:

The PHA should be looked at for its ability to implement the program, its track record as a public housing agency with other rehab programs—in other words, its success ratio.

And, finally, the occupancy of its Mod Rehab Program as well as the section 8 program.

If we have time, and I'm not sure that red light means we don't have any more time, I can go through a couple of the other things that we believe are important.

Senator GRAHAM If you could summarize your recommendations, Ms. Truett, we've been joined by some other members of the committee, I'm sure we'll all have questions.

ONGOING TRAINING IN FINANCIAL AREAS

Ms. TRUETT. We first believe that we should provide ongoing training in the financial workings of past projects, to learn how to spot overfunding and windfall profits to developers.

This training could take place at both the central regional and field office level; establish a benchmark computer program for each rehab deal.

This program would analyze the proper costs for construction rehab costs, land costs, the audited appraisals of acquisition costs and the cost of financing, with special scrutiny of consulting firms.

Training at the local PHA level, as I mentioned earlier, could be done with a video computer prepared by the best U.S. HUD people from the field office, as well as those who are administering good programs on the local level.

REGULAR MONITORING

Regular monitoring, we can't stress that enough, should take place by specially trained U.S. HUD people from the central, regional, and field office. And it should be at least on a biannual regular basis of all production programs. Updating of manuals, should it take place. Computerized rental calculations, including such factors as the rate of return. I believe Mr. Terner covered that very well.

Give consideration to a maximum allowable rate of return from each funding source, whether it be the Mod Rehab rent, and debt service calculations, coinsurance programs, tax credits, tax exempt bonds and other local financing, review exactly what each completed rehab unit is actually costing the taxpayer, and provide a ceiling amount per bedroom size for each local government similar to what has been done in the section 8 Fair Market Rent model.

Instead of more bureaucracy, improved local control of Mod Rehab project's rental structures need to be based on an annual factor, not a one shot in time guess at approprite rate.

A 15-year contract is a long time not to be able to make really substantive adjustments in rent other than on an annual adjustment factor basis.

Consider providing a setaside of Mod Rehab units specifically for nonprofit housing partnerships with a previous track record in rehabilitating and managing low income housing.

This is my last very important point.

SOCIAL SERVICES COMPONENT

Currently, there is no provision in the rent calculations of the Mod Rehab Program for inclusion of a social services component. We feel that probably is the single biggest barrier to a successful Mod Rehab program.

Bricks and sticks are important, no doubt about it. You can't house people without them. But, we think that's 50 percent of the problem's solution.

We think that social services need to be provided and allowed for in such a way, such as perhaps using the profit margin of a nonprofit and plowing that back into services for low income people. Without the economic mixture of individuals and families we see a continuation of the cycle of poverty. Limited role models are available for children. Of the 89 percent female head of households who occupy substandard housing in Jacksonville, investment in social services makes a significant difference in the future of both the children and their parents. We could say the same of the elderly as well.

In a time of rising crime rates due to the annual increasing use of drugs and crack/cocaine, security is an expense that needs to be dealt with and as an eligible expense, both solid rent rehab costs and ongoing management rental costs.

And I'll stop there and try to answer some questions, and I'll try to fill in as best as I can what I left out.

[The complete prepared statement of Judy Truett follows:]

PREPARED STATEMENT FOR SENATE SUB-COMMITTEE ON HOUSING

Moderate Rehabilitation Section 8 Program History

Enacted by the Congress in 1978, the Moderate Rehabilitation Program was designed to provide modest rehabilitation of existing rental properties and rental assistance payments on behalf of lower-income families leasing these units. It is a rental subsidy program which pays base rent and payments for the financing necessary to complete the renovation. Unlike the Section 8 Existing Program, where the subsidy is assigned to a family, the subsidy is attached to the unit for 15 years. This is why this program is attractive to low-income housing developers.

Like the Section 8 Existing Program, the Moderate Rehabilitation Section 8 Program is administered by Public Housing Agencies (PHA), who then apply to their respective field offices for program funding. In a general sense, the Moderate Rehabilitation Program was intended to follow National Housing Policy objectives that included neighborhood revitalization and conservation; expansion of housing opportunities for very low income families; and integration of housing programs into overall local community development strategies.

Need For Moderate Rehabilitation Program

Section 8 New Construction and Substantial Rehabilitation Production Programs of the 1970's were no longer funded as many were too costly. Since the need was still great for affordable housing, a less expensive way to produce decent, safe and sanitary housing for low income families was sought. The solution was to revise the Substantial Rehabilitation Section 8 Program so that rehabilitation of units could take place at a much reduced cost per unit and still encourage private industry to participate in the recognizably difficult field of ownership and management of low income family rental housing. Further, the revised program was to be administered at the local level where it was thought that cost containment could be better controlled.

Moderate Rehabilitation Program Successes

The revised Moderate Rehabilitation Program has provided standard housing to the very low income families at rates they can afford to pay (30% of their adjusted income). This program has resulted in preserving privately owned rental housing stock, especially in large inner cities, that may not have otherwise been rehabilitated. With no vehicle for replacement, had the units not been rehabilitated many more units for use by low income families would have been permanently lost due to demolition.

As well as preserving housing stock, the Moderate Rehabilitation Program addressed another very important National Housing Policy. It secured rental housing that is set aside for low income families. Finally, the Moderate Rehabilitation Program allowed for local level selection of projects to be completed. It enabled the public housing agency to address housing needs outlined in their Housing Assistance Plans.

This may have been one of the most important aspects of the program as local communities regained some measure of control regarding the placement of assisted rental housing for low income families.

Local placement allowed for a much improved economic and social mix of its low income population throughout the city. Further, local governments could better ensure that low income housing rehabilitation could be completed in areas of developing employment. With the review of the Housing Assistance Plan of the U.S. Department of Housing and Urban Development area office, local governments can assure that low income families could have increased access not only to jobs, but also to transportation, health care, shopping, and, most importantly, good schools for their children.

In the very early 1980's, the Moderate Rehabilitation Program allowed local governments that were interested in improving the living conditions for its low income population to plan regularly for a dedicated source of funding for rehabilitation. This program seemed like a small but steady supply of improved housing that local housing planners could include in the local community's Housing Assistance Plan. Progress could then be made toward the national, state and local goal of affordable rental housing throughout the community.

Nearly 1000 units of rental housing have been rehabilitated in Jacksonville since 1981. Jacksonville has 40,000 privately owned, substandard rental housing units and only 2.5% have been rehabilitated under this program in the past 8 years; the need is great, the resource small.

Moderate Rehabilitation Program Failures

As mentioned earlier, the local public housing agency was to apply to their respective U.S. Department of Housing and Urban Development Field Offices for Moderate Rehabilitation unit allocations. These allocations were based upon the need

demonstrated by the local government's Housing Assistance Plan prepared in conjunction with the Community Development Block Grant yearly application for entitlement cities and the local Comprehensive Policy Plan.

During the first year or two of the program, Moderate Rehabilitation units were in fact granted to public housing agencies based upon the local demonstrated need. Developers of large and small scale rehabilitation projects were required to go through the public housing agency in order to apply to rehabilitate their properties. Public housing agencies would publicly advertise and market the availability of their Moderate Rehabilitation unit allocations through a Request for Proposals. After applications were received, the public housing agency would rank and rate the application's made to them by developers and select the ones best suited to meet the policies and goals set out in the local government's Comprehensive Plan and Community Development Block Grant Housing Assistance Plan. Jacksonville's Moderate Rehabilitation Program administrative procedures developed in 1980 have been revised several times and consistently utilized for the awarding of units to developers.

From 1982 on, local governments, like Jacksonville, no longer received a yearly or biannual allocation of Moderate Rehabilitation units. Upon inquiry to the U.S. Department of Housing and Urban Development Field Office, the Jacksonville Department of Housing and Urban Development was advised that available Moderate Rehabilitation units were to be distributed to the states by the Central Office of U.S. Housing and Urban Development.

Jacksonville did not receive any more Moderate Rehabilitation units until 1983 when the public housing agency was approached by a developer from South Florida. The developer urged the Jacksonville Department of Housing and Urban Development to apply for 80 units of Moderate Rehabilitation. In a short time, the request for 80 new units was approved by the U.S. Department of Housing and Urban Development. The City initiated its administrative procedure, advertised the unit availability and received only one application, which was submitted by the South Florida developer. The South Florida developer went into partnership with a local Moderate Rehabilitation developer using financing provided by the Duval County Housing Finance Authority's issue of tax exempt bonds. From this point on developer-brought units were the only way the City of Jacksonville received Moderate Rehabilitation units.

The public housing agency was contacted by a developer, asked to apply to the Field Office of U.S. Housing and Urban Development and to give a specific number of units and a specific bedroom size breakdown on the U.S. Housing and Urban Development application. The U.S. Department of Housing and Urban Development Field Office would then find out from the Central Office that in fact X number of units were available for the City of Jacksonville, and the process of local advertisement would again take place.

The City's Public Housing Authority was approached by a number of developers indicating interest in seeking units for Jacksonville. When it was explained to them that the City's Administrative Plan involved a competitive review and ranking of proposals, many of the developers did not respond.

At the same time that the Moderate Rehabilitation

allocation process changed, the U.S. Department of Housing and Urban Development's budget was decreased. This eliminated many positions in the U.S. Department of Housing and Urban Development Central, Regional and especially the Local Field Offices making it nearly impossible for the U.S. Department of Housing and Urban Development to fully train either its own staff or that of the Public Housing Agencies responsible for accurate implementation of the Moderate Rehabilitation program.

Into this training void came the larger, more sophisticated developers bringing promises of needed Moderate Rehabilitation units to the untrained staffs of local Public Housing Agencies. Developers also offered to complete the Moderate Rehabilitation applications, and various calculation processes; and to manage the Public Housing Agencies' paperwork for recertifying the tenants once the unit rehabilitation process was completed. Untrained Public Housing Agency staffs were often not equipped to deny inflated rent structures and reject ineligible developer fees that were built into project financing due to the lack of adequate training.

Compounding an already flawed system, monitoring by the U.S. Department of Housing and Urban Development was sporadic. This was probably due to the cuts in Field Office staff and the enormous burden of paperwork placed upon those who remained.

There was little assistance available in the form of up-to-date manuals for the local Public Housing Agencies to follow nor was their travel budget sufficient to allow for even limited training and monitoring. This was not true for Jacksonville as the area office is located in our city.

All of these events may have resulted in the concern regarding rental subsidies that the Inspector General is now finding throughout many local Public Housing Agencies who have administered the Moderate Rehabilitation program.

How The Program Failures Can Be Corrected

Awards of Moderate Rehabilitation units should be made to local Field Offices based upon a demonstrated local need. Fair criteria should be used and well publicized to the Public Housing Agencies in advance of notification of fund availability. Some of the criteria that the U.S. Department of Housing and Urban Development should use besides need, are:

1. Ability to implement.
2. Track record of local Public Housing Agency with other rehabilitation programs (success ratio).
3. Occupancy of existing Section 8 Moderate Rehabilitation Program as well as the Existing Section 8 Program.

Oversight of the Moderate Rehabilitation Program by the U.S. Department of Housing and Urban Development must be increased through the following steps:

1. Provide ongoing training in the financial workings of past projects to learn how to spot overfunding and windfall projects to developers. This training must take place at the Central, Regional and Field Office levels.
2. Establish a "benchmark" computer program for each rehabilitation deal. This program would analyze the proper costs for construction rehabilitation, taxes, land costs (via audited appraisals of acquisition costs) and costs of financing with special scrutiny on any consultant firm.
3. Training at the local Public Housing Agency level could easily be done by a video/computer tutorial prepared by the best U.S. Department of Housing

and Urban Development Field Office people and by the current most competent practitioners of a Moderate Rehabilitation project for Public Housing Agencies who administer the Moderate Rehabilitation Program. The value of such a self-teaching method is obvious and the expense of updating a self-taught video is minimal.
4. Regular monitoring of the Moderate Rehabilitation Program and all other housing production programs should take place by a specially trained U.S. Department of Housing and Urban Development team made up of Central Office, Regional Office and Field Office personnel whose specific job is to complete bi-annual reviews of production programs. Cost certification should be made at the local Public Housing Agency level and signed off by the U.S. Department of Housing and Urban Development Field Office personnel as well as by the appropriate State Agency if tax credits are to be utilized. Adequate training at the state level of those administering the tax credit programs should be mandatory by IRS.
5. Update the U.S. Department of Housing and Urban Development Moderate Rehabilitation manuals, which outlines the specific documents that each Public Housing Agency's Moderate Rehabilitation owner's file should have in place prior to a U.S. Department of Housing and Urban Development audit.

6. Computerize rental calculations and include factors such as the rate of return allowed on a project. Distribute the software information for rental calculations to the U.S. Department of Housing and Urban Development Field Office and Public Housing Agency personnel to use in determining standards for rent calculations.

7. Give consideration to a maximum allowable rate of return from each source of funding (not just the Moderate Rehabilitation rent and debt service calculations) such as; co-insurance, tax credits, tax exempt bonds, and other local financing.

8. Review exactly what each completed rehabilitation unit is actually costing the taxpayers and provide a ceiling amount per bedroom size for each local government similar to what has been done in the Section 8 Fair Market Rent model.

9. We strongly urge you not to add another level in the U.S. Department of Housing and Urban Development Central Office of Moderate Rehabilitation projects. Instead, consider approaching Moderate Rehabilitation project review through the tax credit review process at the state level in conjunction with project statistics provided to the State by the U.S. Department of Housing and Urban Development Field Office and Public Housing Agency personnel. Let the facts be established, and at that point, determine if tax credits are warranted. In many cases, good projects needed for low income persons are not viable without the subsidy supplied by the Moderate Rehabilitation program in conjunction with the tax credit to the owner/developers. In other cases it may be determined that no tax credits are warranted.

10. Instead of more bureaucracy, improve local control of Moderate Rehabilitation projects. Moderate Rehabilitation Program rental structures need to be based upon annual factors not a "one shot in time" guess at the appropriate rates. A fifteen year contract is a long time not to be able to make an adjustment in rents of more than the current annual adjustment factor.

11. Consider providing a set aside of Moderate Rehabilitation units of the total available to nonprofit housing partnerships who have a previous track record in rehabilitating and managing low income housing.

12. Currently, there is no provision in the rent calculations for the inclusion of a social service component as a portion of the rental rates. Public Housing Agencies are required by the U.S. Department of Housing and Urban Development regulations to assist only very low income families (those making 50% of area median or below income). This regulation forces very low income families together in multifamily properties. Without the economic mixture of individuals and families, we see a continuation of the cycle of poverty. Limited role models are available for the children

of the 89% female heads of households who occupy subsidized housing. An investment in social services makes a significant difference in the future of both the children and their parents.

13. Housing for the elderly or handicapped provided under the Moderate Rehabilitation program may as well be termed "warehousing" due to the fact that we cannot provide social services. Program redesign and social services must be included as eligible expenses in the rents provided by the U.S. Department of Housing and Urban Development and Congress. Decent housing is not just "bricks and sticks" and debt service.

14. We are in a time of rising crime rates due to the annually increasing use of drugs and crack cocaine. Security is an expense that must be dealt with in the eligible expenses of both solid rent rehabiliation costs and ongoing management of rental property. The poor are being preyed upon by dealers of crack as never before in the history of assisted housing management. The crisis must be addressed and it takes money to do so.

Jacksonville's Department of Housing and Urban Development has taken 5,337 family applications for assisted Section 8 Housing during the past year. This is up 5% from last year and we currently have 3580 families on the waiting list. Some of these families can expect a two to three year wait for assistance. We have utilized all the resources we could secure. Our assignment was to get units of housing for our needy citizens. We have an administrative procedure from which we never varied

for the benefit of any specific developer. The program design may have been flawed, but we utilized it to the best of our ability with federal and city regulations to produce much needed housing.

Jacksonville Department of Housing and Urban Development
Housing Assistance Division
1300 Broad Street
Jacksonville, Florida 32202
(904) 630-3817

Judith A. Truett, Chief
August 2, 1989

Senator **GRAHAM**. Thank you very much, Ms. Truett. I would repeat an announcement from earlier.

We are voting today on the nomination of Dennis Kloske to be Undersecretary of Commerce for Export Administration, and C. Austin Fitts to be Assistant Secretary of Housing and Urban Development.

The roll will remain open until 11 a.m. I encourage each member of the committee, while they are here, to cast their vote with the clerk.

We have been joined by Senator D'Amato of New York.

OPENING REMARKS OF SENATOR D'AMATO

Senator **D'AMATO**. Mr. Chairman, I do. In the interest of time, I ask that my statement be included in the record as if read in its entirety.

Let me commend you for this hearing. I hope we can provide the kind of oversight and the kind of meaningful suggestions that will make our limited funds that Ms. Truett has indicated available on the basis of merit of the projects and not political pressure, and on the basis of need.

Of course, she stressed in a very important area, that when you have such a great demonstrated need, there becomes that problem of finding the kind of program, because one city alone could literally make claim on the limited resources of the section 8 Mod Rehab. Indeed, it has a demonstrated need.

So it's not an easy formula to come up with, but it has to be a formula predicated on the basis of need, and on the merit of that project.

I would hope that we would be able to do that so that we could deal with many of the abuses that have obviously taken place.

Thank you, Mr. Chairman.

[The complete prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR D'AMATO

Senator **D'AMATO**. Mr. Chairman, I am pleased to join you today as we continue the committee investigation into the HUD Moderate Rehabilitation Program. As the reports and investigations continue, the facts about the operations of the program become more and more upsetting.

It is for this reason that I was pleased to receive notification yesterday from Secretary Kemp which outlined his strategy for turning around the management problems of the past. I welcome the aggressive position of the Secretary and look forward to working with you, Mr. Chairman, to address all aspects of this problem.

This hearing will review studies conducted by GAO, the HUD Inspector General, and CRS which assessed the cash flows of 8 projects which received section 8 Moderate Rehabilitation funds. The studies revealed that a variety of Federal housing subsidies were involved with these projects. This committee will determine if these subsidies were used improperly or if they provided excessive benefits to developers.

MODERATE REHABILITATION PROGRAM

The Moderate Rehabilitation Program was designed to increase the supply of rental units for low-income families. By providing a private sector owner with 15 year guaranteed rental subsidies, an owner agrees to upgrade substandard rental housing. In return for the subsidy, the owner makes the housing available to low-income families for a 15 year period. To qualify for the rental assistance, an owner or developer must spend a minimum of $1,000 per unit in repairs or improvements.

HUD CO-INSURANCE PROGRAM

A number of projects that have received rental subsidy through the Mod Rehab Program have also received assistance through the HUD Co-insurance Program. In these situations, HUD co-insures a project's mortgage. In the event of a default, HUD's insurance fund would pay about 80 percent of the outstanding mortgage, and the private co-insurer would cover the remaining 20 percent.

TAX CREDIT PROGRAM

In addition to section 8 rental assistance and HUD co-insurance, many of these projects received tax credits. Tax credits were authorized in the Tax Reform Act of 1986 as an inducement to developers to build low-income housing. Currently, tax credits are allocated through State housing finance agencies. Congress appears to have intended that these State agencies allocate only the necessary amount of tax credits to make a project feasible. However, it is clear that some developers requested and received from State agencies the maximum amount of tax credits—regardless of how many were needed to make a project feasible. These credits, which when combined with Mod Rehab subsidies, generated substantial cash proceeds to the developer.

CONCLUSIONS

By combining proceeds from the sales of income tax credits with co-insured mortgage loans secured by Mod Rehab rent subsidies, developers have been able to generate sizeable cash proceeds from Federal subsidies. These proceeds greatly exceeded the cost associated with acquiring and rehabilitating the property. It is estimated that developers received about $3,500 to $11,400 on a per unit basis.

While the developer's fees are significant, I do not believe that this is the real problem. The true injustice here is that the existence of heavy cash flows indicates that some of the projects may have been feasible without as much subsidy. A more careful allocation of the multiple subsidies may have allowed more units to be rehabilitated. And, as we all know, more rehabilitated units means more families who receive assistance.

In order to respond to these problems, it is my hope that we will focus on two areas of possible legislative reform. First, an oversight procedure is needed to review the total benefits awarded to a project. Many of these projects received a variety of subsidies from different administering agencies—such as HUD, State housing finance agencies, and local governments. These subsidies were allocated for a project with little or no centralized oversight of the total benefits package provided to individual projects. Consequently, more subsidy than necessary was provided to these projects. Developers appear to have been the beneficiaries. It is unclear if this oversight should come from HUD, State housing finance agencies, or another organization.

Second, effective management controls are necessary to ensure that reported project costs are valid. The studies indicate that there is no incentive to minimize costs under the Moderate Rehabilitation Program or the Tax Credit Program. In fact, because developers generally receive a certain percentage of the rehabilitation cost of a project, there is actually an incentive to increase costs. Increased project costs generally result in higher section 8 subsidies. Without adequate oversight of these costs, the Government is vulnerable to providing excessive subsidies.

In sum, the findings of the studies by GAO, the HUD Inspector General, and CRS seem to indicate that combined Federal subsidies for low-income housing could be more coordinated and efficient. At a time when we have such limited Federal resources to address a major housing need, we must maximize our Federal dollars. It is my hope that we can take this information and act constructively to better meet the housing needs of families around the nation.

Thank you, Mr. Chairman.

Senator **GRAHAM**. Ms. Truett, Mr. Terner has indicated that he's been quite successful in a nonprofit without using the Mod Rehab Program, but rather limiting himself to local land use benefits plus the tax-free bonding for debt and the low income tax credits for equity.

What is it in Jacksonville that has necessitated the use of Mod Rehab in order to get developers to do what Mr. Terner has done?

Ms. **TRUETT**. We don't currently have an excellent nonprofit such as Mr. Terner's. As a matter of fact, that's something that the mayor is working on currently.

We presented to our mayor yesterday a very complete and comprehensive report from a citizens committee commissioned specifically on housing.

One of the major recommendations is that we have a nonprofit. We hope that it will be a joint public/private partnership based somewhat loosely on what is being done in Boston.

In the meantime, to produce good rehabilitated units, we do need to count on our private developers. If we didn't, we wouldn't even have the resources that we currently have in addition to those that have come through the rental rehab program, which we also participate in.

Senator **GRAHAM**. Is the principal inducement for the Mod Rehab Progarm the guaranteed 15-year rental stream?

Ms. **TRUETT**. Absolutely.

Senator **GRAHAM**. How do you go about establishing what is the process of determining what that 15-year rental stream will be?

Ms. **TRUETT**. Senator, if I may clarify, does that mean how do you determine the rent structure?

Senator **GRAHAM**. How do you determine the rent structure?

DETERMINING THE RENT STRUCTURE

Ms. **TRUETT**. At the present time, what happens in any Mod Rehab project that in is that we analyze the hard costs that affect the development. The rent is then based on those hard costs, development fee costs, as well as what it would cost to keep the debt service in place.

And that is what we based the rent on. It is a base rent which is also equated to our fair market rent. And we don't go over that fair market rent for the base part of it.

The debt service is another calculation. It's separate.

Senator **GRAHAM**. I'd like to go into those terms. When you say base rent will not exceed fair market, can you explain that?

Ms. **TRUETT**. Fair market rent, in general, is provided by the Federal Government on an annual basis. A two-bedroom ceiling, including the utilities, might be, say, $425. So our base rent when we're going through any kind of a deal with the developer is based on the $425 ceiling, including the utilities, if they were all paid, as well as what it's going to cost to service the loan.

Those two figures, and I have, in fact, with me a calculation form—not a real project, but one that is similar to the ones we do. And I can probably provide a copy of that as part of my statement this morning if you would like to look into it.

It's not the simplest thing in the world to calculate. Basically, the monthly rent cost approach is based on the property debt service. The utility is paid by the owner. Insurance, taxes, management and routine maintenance, and reserve for replacement, return on investment, total property annual base rent.

Then, an occupancy factor up between 95–100 percent. Total annual property base rent adjusted for vacancy and collection losses.

This is a whole formula that we go through, as a matter of fact, that is on a HUD-provided form, that we go through at the local level to determine what the base rent is going to be per bedroom size.

Senator GRAHAM. The formula is base rent plus debt service. Is that correct?

Ms. TRUETT. That's right.

Senator GRAHAM. What would a normal unit which has the base rent of 425, what would the total rent be when you add debt service? If we could get a hypothetical?

Ms. TRUETT. Let me see if I can pull that out of here. Under the formula that we have, this is a 200-unit property, 200 one and 200 two-bedrooms. We ended up with a monthly contract rent of two bedrooms being $463 and the three bedroom being $578.

Senator GRAHAM. Could you give me those numbers again, please?

Ms. TRUETT. Yes, sir. Two bedroom is $463. Three bedroom is $578. that's a Mod Rehab FMR. It is a maximum for the two bedroom of $535. The utility allowance is $75. And the maximum HUD contract was $460.

Let me see if I have it broken out here. Base rent by bedroom size allocation. It's a whole formula that's quite lengthy, but the two-bedroom base rent was $281 on that particular equation.

Senator GRAHAM. I guess I don't understand how it is that Mr. Terner in San Francisco is able to provide housing for $395 per month—is that the figure you gave?

Without a 15-year guaranteed rent. And it's costing $463 or $578 in Jacksonville under this base rent plus debt service formula.

Ms. TRUETT. Well, as he mentioned, each case is very, very different. And what it costs for land in Jacksonville as opposed to land in California I'm sure would be quite a bit different—higher, I'm sure, in California.

I wasn't able to hear the beginning of his presentation. What I would assume is that he got a considerable amount of local support in land write-downs.

Mr. TERNER. Not write-downs, but density increases.

Ms. TRUETT. That's not necessarily the case in Jacksonville. In order to encourage the implementation of a piece of property in a very low-income neighborhood that is plagued with crime and many of the social problems that low income people have to deal with on a daily basis, we have to find out what the cost of the property is from the seller to the buyer.

We have to go through all the usual real estate determinations to come up with whether this deal is going to be possible. The incentive besides the 15 years is the fact that he's got to make some kind of profit on it, because the developer not only develops it, but he has to manage it for that 15-year period of time. And that is not the easiest thing to do with low-income property.

It's very much of a risk and I want to impress on everyone that it is a lot of risk for a developer. It's one thing for a local government to say that we're going to do rehab jobs ourselves.

It's quite another thing for someone to go out and borrow $3 million from whatever source they borrow it at a higher rate of interest, and then come back in and try to make all the figures work.

I'm not going to say that there is not room for some padding in there. I'm sure there is. But, each deal is a very different set of circumstances. And when you put in the profit motive and that management fee—cost, I should say—it's considerably higher.

Senator **Graham**. I have some further questions but I'll defer to Senator Mack for any questions he might have.

Senator **Mack**. Thank you, Senator Graham.

Ms. Truett, I was recently in Jacksonville. We toured the Blodgett Project. There are some very significant things happening in Jacksonville. You all are to be commended for the work that you're doing.

Ms. **Truett**. Thank you.

Senator **Mack**. I am going to read a little from a recent article that was written with respect to the housing problem, and it may touch on this discussion that you all had about the differences in rental rates.

It may have nothing to do with it, but I'm going to throw that out anyway and, frankly, get both of your reactions to it, if you could.

In this article, it said:

> Ever since the 1930's, when the Federal Public Housing Programs were launched, the Federal Government has been a honey pot for developers and housing financiers. The pot has been made sweeter by the design of these programs. Construction costs and profits have not only been subsidized in various ways but under the section 8 program, enacted in 1973, private landlords essentially were given a Federal guarantee that they would receive a fair market rent on every unit they leased to a low-income family.
>
> Under this arrangement, developers and owners reap enormous profits, yet face virtually no financial risk, while loan and rent guarantees encourage inflated housing costs.

As I say, I just throw that out to get a reaction from either of you or both of you.

Senator **Graham**. Ms. Truett.

GUARANTEED PROFITS WITHOUT RISKS

Ms. **Truett**. I wouldn't say that they get enormous return, per se. To do a very good job of providing low-income housing, you do have an enormous risk involved. You have a much higher rate of maintenance on a place than perhaps you would in what's called conventional housing. Low income people tend to have large families, and part of the reason why I said earlier that bricks and sticks isn't the only answer to housing, is we end up warehousing low income people and not providing services in conjunction with the housing as a requirement by the owner/manager of low income housing, it is not a requirement other than if the PHA imposes that, which we do

We monitor that very closely. But, to say that it's strictly windfall and all negative is absolutely not true. There is a risk involved to any developer who goes into this private or nonprofit or Government for that matter. Blodgett being an example, it is not the easiest thing to manage that. It is not inexpensive; to do it well is a costly thing. That's what was evidenced in the way that the Mod Rehab Program was set up.

Senator **Mack**. Mr. Terner.

Mr. **Terner**. I don't know who the author of that article is, but I would say he or she shows a lot of insight into what's happening down on the streets and in projects.

I would agree with Ms. Truett in saying that each development is different. And it's really hard to know the exact reason for the differentials between a project in Jacksonville and a project which I was referring to in the San Francisco area.

But I would say this, that you know by the evidence on the table—by the high-priced consultants, the finders, the phone callers, et cetera—that the program where it is now so lucrative that that article is certainly true.

To my way of thinking, the biggest risk the developer is taking there is that his phone call doesn't have enough juice in it, he's not going to get the deal.

Senator **Mack**. He might have paid a little bit too much for the phone call.

Mr. **Terner**. Or he might have done that. There is risk in all of this. And, certainly, the two projects that I showed you had $11 million worth of debt. That's real risk to our company.

The issue though is the program structure as it is now. In many cases, it turns the developer into an administrator of the Government subsidy program. He or she loses his or her development status, the entrepreneurial or business person status. They become an administrator for our tax dollars going down the drain.

And that is so lucrative that you're going to get these phone calls, et cetera. I don't say that in every single case you don't have to in some cases stretch and do something extreme, such as maybe even guaranteeing cash flow for a period of time to get any activity at all going.

But, the evidence is on the table that it's so lucrative down there, you're going to get people doing some fairly unsavory things that feed at that trough.

Senator **Mack**. Is it reasonable maybe to assume that the reason we might get a little bit different viewpoint from the two of you is that, depending on the type of program that you're dealing with, you're going to have excesses and less risk and a higher chance for feeding at the trough from one program than from another?

Mr. **Terner**. Yes, I would say so.

Senator **Mack**. I think that that's all I'd really like to raise at this point.

Senator **Graham**. I would like to return to the question of the income tax credits. Mr. Terner gave us some description of how those credits are allocated in California.

Could you comment as to how they're allocated in Florida?

INCOME TAX CREDITS

Ms. **Truett**. I'm not intimately familiar with that program, Senator, but we have utilized it in Jacksonville on two occasions. In fact, the very first tax credit used, I believe, in Florida was with a project that was being rehabilitated, not with the Mod Rehab Program but the Rental Rehabilitation Program in Jacksonville.

And that is a very good example of excellent use of the resource. I'm not going to say, however, that there was not probably some excess money involved in there.

But, this developer chose to take a large portion of that excess money, he was a prviate developer, and he utilized it in social services for the clients that he was serving in Jacksonville.

Senator **Graham**. Was that decision a voluntary decision?

Ms. **Truett**. Yes, it was. Spurred by us.

Senator **Graham**. But the developer had the option of walking with the excess money he collected.

Ms. **Truett**. Yes, that's correct.

I'll very briefly say what the project was. It was a project of 304 units. It as developed under, I think it was a 221(D)(4) project. It was resold, and sold.

But the fourth sold, people in California owned it. They totally dried it up. They didn't put $1 back into it. And it was—pardon me—it was a hell hole. There were dead bodies in the dumpsters. We had section 8 certificate holders in that program project. We had to certificate all 263 of them within a 1 month period of time and help them to find other accommodations, because it deteriorated completely in a long, dribbling sense, and then it just fell right off.

This developer came in from out of town, looked at the project, decided that it was worthwhile. He came to us and said:

> I would like to try to rehab this project. He got money through a deferred payment loan program. Very successful, while not nearly as expensive perhaps as Mod Rehab.

He developed it, rehabed it in conjunction with the lender that had the paper in the first place.

Senator **Mack**. Excuse me. What was the type of program?

Ms. **Truett**. The Rental Rehab Program. It's also a rehab program that's quite successful with HUD.

What they did was to take then their finished product to get the tax credit. When they were finished, they had 300 units. It was definitely for low income people, although it was all low income people, not just 50 percent of median, but it could have gone all the way up to market if the people wished to do that.

A hundred of those units had a voucher attached to that project for 1 year. So it got them started in being able to pay their debt service. They then took the whole package and went through the Florida Tax Credit Office at the Department of Community Affairs.

They were able to market that quite successfully as it was a 100-percent low income, as it turned out, project.

They didn't have to do that, but they did. But what they also did with the profits from both the rent structure and what they were able to syndicate, I guess, because I'm not intimately familiar with those details, they put in a day care center. They put in two pools. They put in children's activities. They have complete, round the clock, 24 hour, 7 days a week security, which they had to do to save it, to continue to reclaim it from the drug dealers.

That was the only way to do it. It's a model, frankly, in Florida. And it's something I would hope would be repeated.

And one thing that I would urge you. If anything that we get out of this, if we encourage—I hate to say force, because I don't like it that way, but in whatever way possible, that excess X-number of profit past, say, a reasonable profit of 5–10 percent, had to go into social services for the low-income people that we are serving, that would make all the difference in the world. Absolutely all the difference in the world in the project's success. And whether or not we taxpayers were just being ripped off or not.

Mr. TERNER. Can I add to that, Senator?

The other thing is put them in jail. Put the people who are doing this—really punish them. It will send a message out there. Or this is just going to continue.

Senator GRAHAM. On the issue of tax credits, Mr. Terner or Ms. Truett, do you have any rule of thumb as to how many units of subsidized housing can be developed for, let's say, every $1 million of tax credits?

Mr. TERNER. I don't, Senator Graham. I'll be happy to try to research that under a different series of assumptions.

Senator GRAHAM. Thank you very much. We would be interested in your assessment of that.

Ms. TRUETT. I would say the same.

Senator GRAHAM. Thank you.

Mr. TERNER. I will tell you this. I'm just doing a quick bit of mental arithmetic. There are $3 million in tax credits in those two projects, Magnolia Plaza and Pacific Oaks. Actually, $3.1 million. There are 229 units, half of which are tax credit units. So that's 115 units.

And we've gotten $3.1 million, actually $200,000 a year over 7 years, with each of those projects from the tax credits syndication.

That's a rough calculation, but that just gives you something very quickly. I prefer to enter something on the record.

Senator GRAHAM. So, roughly, $200,000 a year for 115 units, or something less than $200,000 per year we'd benefit.

Mr. TERNER. It's actually double that because the $200,000 is in each of the projects. That's a total of $400,000. But, rather than do back of the envelope arithmetic, I really would prefer to give you a researched answer to that because the answer will differ under different assumptions.

And I will enter that in the record.

Senator GRAHAM. Ms. Truett, you were commenting about the changes that took place in the Mod Rehab Program in the early eighties.

At that time, there were, as you've already indicated, a variety of HUD programs that were aimed at rehabilitating and providing rental subsidies for low-income families.

What was the standard practice in terms of the dollars per unit that would be expended on Mod Rehab projects as opposed to those that were rehabilitated under the preexisting large-scale rehabilitation programs?

Ms. TRUETT. I don't want to mislead you, but it is my impression, as I was not involved with the PHA at that time, but it is my impression from my work at the State level that it was a very, very expensive program—new construction and substantial rehab section 8.

Such that if I'm not mistaken—this sticks in my mind—that a unit of new construction and substantial rehabilitation, one bedroom in Miami, the rent was $1,100-$1,300 a month for a 15-year period.

Nothing could have cost that much to develop. Nothing. Not the Taj Mahal, I'm sure.

So, when this program came in and we were looking at much more modest amounts of rehabilitation and all of these other boondoggles were gone, this was the only game in town: Mod Rehab.

There was still ample room in the program as the rules set it up for people to make a healthy profit and do a decent job of Rehab.

To be specific, rehab in Jacksonville, the owners could come in and do substantial rehabilitation, got the whole thing and put all new everything in it and still utilize the Mod Rehab Program.

I can't give you specific figures on that, but I know that's reality. So, the rents were still lucrative enough to do that under that structure.

Senator GRAHAM. When this program was originally launched, it was intended to be for relatively modest rehabilitation, let's say, under $10,000 a unit. Substantially under $10,000.

There seems to be some evidence that, as the program changed its character, the scale of rehabilitation became greater, that larger levels of rehabilitation were being financed through this program.

Is that your experience?

Ms. TRUETT. Yes, sir.

Senator GRAHAM. Is it also your experience that early in the program, it was more focused on small projects, maybe even scattered housing projects? And as it evolved, it became focused on larger projects?

Ms. TRUETT. That's correct. I will add one thing perhaps of enlightenment to that, that we can now, years later, say, 7 or 8 years later, are having the most problems with those deals, smaller mom and pop, you might say, rental Mod Rehab projects, because early on, we didn't insist that they do certain things that they should have done.

So, now what we have 7 years later is not enough rent in the base rent to be able to make corrections for things that should have been done at the beginning.

So, from the PHA standpoint, you're better off actually with a larger amount of rehab going on in the beginning rather than, say, just doing the plumbing and not doing the roof, even though it needs it.

That kind of thing happened in the early program, partially I think because were trying to be conservative and partially because we didn't realize down the road, we weren't sophisticated enough at the time to know that, down the road, it was going to cost everybody, mostly the developer, the owner, a lot more money. He was going to have to go back and keep the unit up to housing quality standards.

If he'd done what he should have done at the beginning and been a little more generous in the beginning, we wouldn't have problems we're facing now where we have to terminate some of the earlier Mod Rehab contracts because they don't meet the housing quality standard.

Senator GRAHAM. Senator Mack, this will be the last round of questions for this panel. I would ask if both of you could remain at the table and if panel two would be free to come forward, so that when we get into the questioning of panel two, we could include all five.

Senator Mack?

Senator MACK. Thank you, Senator Graham.

Ms. Truett, in your statement, you, in essence, said: The reduction in the staff, I think, in the early eighties, 1982–83, resulted in a situation of fewer people I guess to do the same job, not well enough trained in their own jobs to be really of assistance to local communities.

Have you sensed that that situation has changed at all in this period of time, or is it still that bad?

Ms. TRUETT. I would say, through the reduction in force that's happened over the 8 years, I find we have an excellent local office, just one of the finest around.

And I am really in a position to know that.

Senator MACK. The local HUD?

Ms. TRUETT. Our local HUD office, the personnel is wonderful. They're the hardest working people I know. They want to do what's right. The pressure is extremely heavy on them: don't make a mistake, with papers and projects that come through daily that high stacks of paper, that's an awful lot of pressure to put on any staff, and then take their resources away, additional staff to make sure those mistakes don't happen.

They barely can keep up with what's pushed at them, let alone go out and see to it that monitoring is done the way you should do it.

In Jacksonville, we've been monitored regularly. They're also located in Jacksonville, the HUD office. But, to go out there and do the teaching that's needed as a follow-up to the Mod Rehab—there problems are found at the local level of operation of a Mod Rehab Program. There's no time and there's no money. There's no travel to get out there. That's a big problem.

Senator MACK. You mentioned training and regular monitoring. I think you also indicated limited returns. This is what needs to be done to correct the problems.

Could you expand on limiting the return a little bit?

LIMITED RETURNS

Ms. TRUETT. I'm glad you asked me that because that's one I didn't cover very well. What we would urge in Mod Rehab project review as well as tax credit review is a process that includes those in the know at the local Fed HUD level as well as the local PHA level and the staff of the State's tax credit; whether that's a DCA or a housing finance agency is irrelevant. Whoever it is. But those folks should get together on a very regular basis.

And what we would actually urge is that they get together on every one of these projects that are coming through, look at whether this piece is separate over here and we look at what we have to look at under our Mod Rehab regulations, then, this set of rules under IRS and the tax credit is looked at separately. No one looks at the whole picture. No one says: How much per unit is this actually going to cost the taxpayers?

The people who can do that project review, I feel the best, are the people at the local level, trained people at the local level, who see this and connect. They can make the best determination rather than sending it back up to HUD to have another level of bureaucracy, so to speak, that's going to impede the production of housing. Something that's done at the local level.

And then, if final approval needs to be done at central, fine, but I do think that the intense scrutiny needs to take place at the State and local level.

Senator MACK. Mr. Terner, let me just get you to react to that limiting the return. In the sense, where we had a chance a little earlier to talk about what made those projects work, we really saw that there were a lot of different aspects that encouraged that project to be developed and made successful a density bonus land purchase, tax credit, tax exempt bonds.

My only concern is I don't want to have someone eliminating some of the programs that have allowed that project to be successful. So I guess what I'm asking, can we do what Ms. Truett has suggested without driving off the good in development?

Mr. TERNER. I think there are developers who would be very willing to work for limited returns. We have many partners—Dick Adams of Adams and Briggs, for example, in the San Francisco area, who works on a voluntarily limited return.

I think, if the return is cut too thin, you're not going to get any action and you just cranked it down so much that nothing happens.

When the returns are obscene, you'll get the newspapers filled with the kind of scandals we're reading about every day.

I think you try to strike a balance point here. You want a reasonable return and I would say that developers in that 5 or 10 percent range, that is reasonable return. That's a lot of action. There's a lot of entrepreneuring and a lot of investing out of the private sector with those kinds of returns.

And, you know, it's not only the developer, it's the lender, and it's the equity investor who are seeking those returns. And they'll crank down on the developer if those returns aren't available, if those cushions aren't there to buffer them from any mistakes the developer might make.

But there is a reasonable amount of return and I have a little bit of concern about capping that return too rigidly because, then, you don't get the developer driving to save every last penny because there's no incentive to do so.

So, once again, for pots of limited resources, the Cranston-D'Amato says:

> Compete for those limited resources. Show the Government. The burden of proof is on you, the applicant, you the community, you the developer. Show the Government what kind of public benefit is going to derive dollar for dollar.

And we'll judge. We'll make a judgment based on a public benefit test. Then you're going to get developers voluntarily remitting their return because they want to win this competition. They want to show the maximum amount of public benefit they possibly can.

I think that's the wisdom in that bill. And that can be I think a better situation than some of the categorical grants now. They're continually forcing square pegs into round holes. And some of the abuses that you're seeing of these guaranteed cash flow problems.

Senator MACK. Thank you very much.

Senator GRAHAM. We've had a call for a vote on the Senate floor. This comes at a propitious time because we were about to start the second panel. If the second panel would take their place, Senator Mack and I will go vote and we will return and resume.

Thank you very much.

[Recess.]

Senator GRAHAM [presiding]. I call the meeting to order. I apologize for that interruption, and also for similar interruptions that are likely to be occurring. We're in the process of voting on a number of amendments and a cauter vote on the Defense Authorization Bill.

As we come to those votes, we'll take recesses.

The second panel today is composed of individuals who have been examining various aspects of the HUD program. I would like to call first on Mr. John M. Ols, Director of Housing and Community Development, Resources, Community and Economic Development Division of the U.S. General Accounting Office.

Mr. Ols, we've been joined by Senator Sarbanes.

Do you have an opening statement, Senator?

Senator SARBANES. No, I don't, Mr. Chairman.

I very much hope I'll be able to stay, depending on what these schedules are like.

I'll certainly review the material and I'm very strongly supportive of the hearings you are holding.

Senator GRAHAM. Thank you, Senator.

Mr. Ols.

STATEMENT OF JOHN M. OLS, JR., DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. OLS. Mr. Chairman, I'd like to request that my statement be included in its entirety in the record and I'll try to summarize it for the committee.

Senator GRAHAM. Thank you very much, Mr. Ols. I would make a request to each of our panelists particularly in light of what is likely to be a fairly disjointed hearing.

Mr. OLS. Before I start, I'd like to recognize five key people that helped us with this project. We've been working on this at the request of the committee for probably around 45 days.

You've heard a lot of things from prior witnesses, and now from people who are out in the field have confirmed what we found from a cash flow analysis actually did happen and does happen.

Dennis Fricke was my Assistant Director, Rick Green, my Evaluator-in-Charge; Margie Arman from our General Counsel's office worked with us on disclosure of tax information, which is a part of our presentation today, and Pat Doerning, an operations research analyst on our staff.

And Joe Guggenheim was our consultant on the Low Income Tax Credit Policies. And as we get into tax credit type of questions, Mr. Chairman, I might have to call on our experts to talk about the tax policies and how it relates to the entire program.

We appreciate the opportunity to assist you and the committee members today by looking at why did these projects become so enticing that developers could afford to pay substantial consultant fees for these projects.

Briefly, our analysis of eight projects showed that the developers received $250,000 for a 36-unit project up to $2.1 million for a 352-unit project above the cost to acquire and rehabilitate these projects. These substantial proceeds were basically a direct result of the sale of these tax credit eligible projects to private investors. In this manner, developers were able to realize substantial gains on their limited investments while undertaking very little risk.

Aside from tax credits, the Mod Rehab Program grants developers a 15-year rent subsidy for units set aside for low income families. The HUD IG has stated that the rehabilitation costs, upon which the rental subsidies were based were improperly inflated, leading to excessive rental subsidy payments from HUD. According to the IG's April 1989 report on this program, for the eight projects we looked at, the excessive subsidies could total around $25 million over the 15-year period.

This situation evolved because multiple benefits were awarded to eligible projects by different administering agencies such as HUD, State tax credit allocation agencies and local governments, with little or no centralized oversight of the total benefits package provided to individual projects.

As a result, we believe some projects received more financial assistance than would have been required to encourage project rehabilitation. Obviously, this situation has resulted in the expenditure of more Federal funds for fewer subsidized or rehabilitated low income housing units at a time when the demand for such units far exceeds their supply.

The Mod Rehab Program guarantees a Federal rental subsidy for 15 years, thereby providing the owners and the developers with collateral that they can use to secure possibly low interest rate mortgages and to finance the projects' rehabilitation costs. In recent years, with the discontinuation of other HUD subsidy programs such as the Substantial Rehabilitation Program, the Mod Rehab Program has been used to help finance extensive project rehabilitation. In conjunction with the subsidies provided under the Mod Rehab Program, HUD also often provides additional assistance by coinsuring the project's mortgage. In the event of a default, HUD's insurance fund would pay about 80 percent of the outstanding mortgage and the private coinsurer would pay the remaining 20 percent; thus, little, if any, risk to the developer and, in fact, all eight projects that we have discussed in our prepared statement were all coinsured projects.

I'd like to just mention a couple of things about the tax credits without getting into the 1986 act, but about how it works and how it will play out in the example I will share with you.

The tax credit is computed at about 9 percent of certain construction and rehabilitation costs associated with bringing the housing on line. An additional tax credit of about 4 percent can also be obtained for project acquisition costs exclusive of land costs.

These credits are provided annually for 10 years. Because tax credits provide dollar for dollar reductions in tax liability, credit eligible projects are commonly sold by the developer through syndicators to investors. In this way, the developer through syndicators converts future tax credits into cash, usually received within 3 to 4 years of the project conception. Basically, when it's ready to be occupied.

For the eight projects we reviewed, I've attached pro forma schedules to my prepared statement. These schedules summarize the cash proceeds that the developers received.

In developing these schedules, we consulted with a variety of individuals who are recognized as experts in project development, real estate finance and low income housing tax credits. These experts agree that our schedules provide a fair and reasonable basis for estimating cash proceeds received by the developers.

The eight projects we reviewed included the three projects specifically requested by the committee—Baltimore Gardens in Las Vegas, NV, Sierra Point in Clark County, NV and Pebble Creek Apartments in Arlington, TX.

All of our eight projects were identified in the HUD inspector general's report as having received excessive subsidies under the Mod Rehab Program.

Basically, we used the inspector general's fact-gathering information, which short-cut our learning curve in getting to the information we needed to discuss the cash flow process rather than going out and developing new information on each particular project.

That was our reason for starting from that point. For instance, one project the HUD inspector general identified as excessive rental subsidies amounting to $329,000 annually, which came out to $4.9 million over the 15 years that these subsidies are to be provided, and basically that is project two in our attachment to my prepared statement.

While we did not attempt to validate the inspector general's findings to the extent that excessive or inflated costs are incurred in the costs associated with project acquisition and development, the cash flows to developers could be somewhat greater than we have determined.

I would personally like to thank the HUD IG, Paul Adams and his staff for their cooperation and assistance in our examination.

Regardless of the extent of excessive costs, by combining proceeds of the sales of income tax credits with coinsured mortgage loans secured by moderate rehab rental subsidies, developers were able to generate sizable cash proceeds. Tax credits awarded for the eight projects range from about $896,000 in one project to about $5.8 million in another.

When the developers sold their ownership interest in the project along with the related tax credits and these proceeds were combined with mortgage loans and other sources of funds, the developers realized cash proceeds that greatly exceeded costs associated with acquiring and rehabilitating the properties.

As I mentioned earlier, the cash flows ranged from $254,000 to $2.1 million for the eight projects examined. On a per unit basis, that range would be $3,500 per unit up to a high of $11,400 per unit.

Before continuing and with your approval, I would like to walk the committee through one of our project analyses that I think will bring all this together and show how we came up with our results.

Senator **Sarbanes**. I think that's an exceedingly good idea. I was just about to ask the Chair if we might do that.

Senator **Graham**. Our witness, in addition, has other qualifications, is also very anticipatory.

Mr. **Ols**. It's not an easy process. I think your two witnesses on the first panel talked about trying to work this through and see how it plays out.

I think it convinced us that our figures, even though only an analysis of the financial statements, that we are on the right track. I'd like to just walk you through it and we'll start with the top half of the chart, which is source of funds.

Senator **Graham**. Excuse me, Mr. Ols. Of the numbered projects——

Mr. **Ols**. This is project four, but I think we also provided copies of the actual chart for your use. It will be called exhibit 1, or Estimated Cash Flow. It just doesn't have a lot of the footnotes. That will make it easier.

It is project four in the detailed statement, and we are just using it as an example. We have no reason in mind on that project versus any other one. It's a good one to walk our way through the various things that happened.

We'll start with the source of funds, which is the top part of the chart. The mortgage loan at $6.5 million and the owner's cash investment of $45,882. Actually what he had to take to the table to close the settlement.

These are firm figures actually provided to us by the mortgage company off the settlement sheet. We're trying to show you where we made some estimates and where they're really firm.

The tax credit proceeds of $2 million—total tax credits were $5.1 million—were actually provided to us by the State as far as what was provided in total, and then we used assumptions as we footnoted in our pro forma schedules. Roughly selling the tax credits at 45 cents on the dollar, discounting it over a period of time of 3 to 4 years, we allowed that a net tax proceeds from selling these at $2 million, it gives you a total source of funds of $8.6 million.

The application of funds and how funds were spent on this project shows an acquisition cost of $2.9 million, a development cost of $4.0 million, which is on the bottom half of the chart.

Senator **Graham**. Can I ask a question?

How many units were in this?

Mr. **Ols**. Two hundred and nine. It will be at the very bottom of the chart—209, where we compute out the per unit costs, or per unit proceeds.

GAO Estimated Cash Flow — Sources and Applications of Funds

Project 4		
Sources of Funds:		
Mortgage Loan	$6,549,000	
Tax Credit Proceeds	**2,078,602**	
Other	0	
Owners Cash Investment	45,882	
Total Sources of Funds		$8,673,484
Application of Funds:		
Acquisition Costs	$2,900,000	
Development Costs	4,021,947	
Developers Fee	804,389	
Estimated Escrows and Prepaid Expenses (1.5% of Mortgage Loan)	98,235	
Gross Total Applications	7,824,571	
Less: BSPRA	(363,020)	
Net Total Applications of Funds		$7,461,551
Proceeds To Developer at Completion of Development		
Estimated Proceeds To Developer		**$1,970,440**
Estimated Proceeds To Developer Per Unit (209 Units)		**9,428**

Senator **Sarbanes**. Could I suggest for purposes of exposition, it might be better if you just read the figures out? It's $2,900,000, et cetera, instead of 2.9, and so forth. Just so that we really are able to follow exactly what we're talking about.

Mr. **Ols**. I will use the actual figure, Senator.

The acquisition cost of $2,900,000, the development costs of $4,021,947 are again actual cost figures right off the settlement sheet, provided to us by the mortgage company.

We then calculated a developer's fee which is limited in various States by various State rules. It's either 10 percent of 20 percent, depending on the State allowance requirements.

And in this case, because it was in Colorado, 20 percent is what their allowance is. That's why we used the 20 percent figure of $804,389. That is computed off the development costs, allowable development costs.

And that's how you come by with the 20 percent factor.

Senator **Sarbanes**. Is that a fee the developer in effect puts in his own pocket?

Mr. **Ols**. Yes, it is.

Senator **Sarbanes**. So, on this project, before we start talking about other benefits, he gets $804,000 into his own pocket. Is that correct?

Mr. **Ols**. As you work it out through the cost, yes, that would be true. We also estimated escrows and prepaid expenses at 1.5 percent, which is your next line item. That arrives at $98,235. That gives you a gross total application of $7,824,571. We back out the builder and sponsor's profit and risk allowance, which is already included in the development costs above. We just wash it out because it's in the develoment costs and we didn't want to count it twice.

We back it out at $363,020. That gives you a total application of funds of $7,461,551. To calculate the total proceeds of the developer, you start with the total funds at the top right of the column—$8,673,484. Subtracting out the applications of funds—$7,461,551.

You add back in the developer's fee, which is under the application of funds, the $804,389. Now, you deduct what he had to lay on the table at the settlement, which is his cash $45,882.

That calculates then to the bottom line figure of excess or estimated proceeds to the developer when everything else is considered of $1,970,440, or per unit calculating now the 209 units, into that figure of $9,428.

And I might say, stated another way, this is the profit of the developer less any income taxes he would have to pay on that figure—$1.9 million and $9,428 per unit, which I think, as the committee had asked us to look at, shows how one can afford to pay consulting fees some consider excessive when you're paying $1,500 per unit; when you look at what he's getting here per unit of $9,428, you can see how you can afford to do that and still reap substantial proceeds on a particular project.

[The complete prepared statement of John M. Ols, Jr. follows:]

United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
9:00 a.m. EDT
Wednesday,
August 2, 1989

Project Developer Cash Flows Under HUD's Section 8 Moderate Rehabilitation Program

Statement of
John M. Ols, Jr., Director, Housing and
Community Development Issues
Resources, Community, and Economic Development
Division

Before the
Committee on Banking, Housing, and
Urban Affairs
United States Senate

Mr. Chairman and Members of the Committee:

We appreciate the opportunity to assist the Committee in determining why developers found the Section 8 Moderate Rehabilitation Program so enticing that they were willing to pay substantial consultant fees to win projects. Although our work is not yet complete, we are able to provide preliminary information on this situation.

Briefly, our analysis of 8 projects showed that developers received between $250,000 for a 36-unit project to $2.1 million for a 352-unit project above the cost to acquire and rehabilitate these projects. These substantial proceeds were basically a direct result of the sale of these tax credit eligible projects to private investors. In this manner developers were able to realize substantial gains on their limited investments while undertaking very little risk. I should add that low-income housing tax credits were first introduced with the Tax Reform Act of 1986.

Aside from tax credits, the Moderate Rehabilitation Program grants developers a 15 year rent subsidy for units set aside for low income families. The HUD IG has stated that the rehabilitation costs upon which the rental subsidies were based were improperly inflated leading to excessive rental subsidy payments from HUD. According to the IG's April 1989 report on the Moderate Rehabilitation Program, for the eight projects we reviewed excessive subsidies could total up to $25 million over the 15-year period.

In summary, this situation evolved because multiple benefits were awarded to eligible projects by different administering agencies such as HUD, state tax credit allocation agencies, and local governments, with little or no centralized oversight of the total benefits package provided to individual projects. As a result, we believe some projects received more financial assistance than would have been required to encourage project rehabilitation.

Obviously, this situation has resulted in the expenditure of more federal funds for fewer subsidized or rehabilitated low income housing units at a time when the demand for such units far exceeds their supply.

To better understand our information, I believe it would be useful to first describe the Section 8 Moderate Rehabilitation Program and the low-income housing tax credits. I will also discuss our estimates of the cash proceeds to developers for the projects we reviewed.

MODERATE REHABILITATION PROGRAM

The Moderate Rehabilitation Program was designed to increase the supply of rental units for low-income families. Under the program, owners agree to upgrade substandard rental housing in exchange for guaranteed rental subsidies for 15 years. To qualify for guaranteed rental subsidies, an owner or developer must spend a minimum of $1,000 per unit in repairs or improvements to bring the unit into compliance with HUD's housing quality standards.

Once a project is selected for the program, the owner enters into a Section 8 rental contract that specifies the project unit's rent. Within specified limits, the rent is set at a level high enough to service the debt associated with the acquisition and rehabilitation cost of the project. The low-income family generally pays rent equal to 30 percent of its adjusted income and HUD subsidizes the difference between this amount and the contract rent.

The guarantee of a federal rental subsidy for 15 years provides the owners or developers with collateral that they can use to help them secure mortgage loans to finance the projects' moderate rehabilitation costs. In recent years, with the discontinuation of

other HUD subsidy programs, such as the Substantial Rehabilitation Program, the Moderate Rehabilitation Program has also been used to help finance extensive project rehabilitation. In conjunction with the subsidies provided under the Moderate Rehabilitation Program, HUD also often provides additional assistance by co-insuring the project's mortgage. In the event of a default, HUD's insurance fund would pay about 80 percent of the outstanding mortgage, and the private co-insurer would cover the remaining 20 percent.

TAX CREDITS FOR LOW-INCOME HOUSING

The Moderate Rehabilitation Program has been coupled with tax credits for low-income housing. These credits were authorized in the Tax Reform Act of 1986 as a 3-year program, which, like the Moderate Rehabilitation Program, was intended to increase the supply of affordable rental housing for low-income persons. For low-income housing, where the prospects for other profit sources--cash flow from operations and gain on the sale of property--are limited by the nature of the operation, tax benefits have been critical in inducing developers to get into the low-income housing business. Prior to the 1986 act, accelerated depreciation was a primary tax incentive in real estate development.

The 1986 act eliminated almost all tax benefits for real estate development, while creating low-income housing tax credits. State credit allocation agencies were charged with the responsibility for establishing an allocation process to parcel out tax credits which are available to states at $1.25 per capita. The tax credit is computed at about 9 percent of certain construction and rehabilitation costs associated with bringing the housing on line. An additional tax credit of about 4 percent can also be obtained for project acquisition costs, exclusive of land costs. These credits are provided annually for 10 years. Because tax credits provide dollar-for-dollar reductions in tax liability, credit-eligible projects are commonly sold by the developer through syndicators to investors. In this way the developer, through syndicators, converts future tax credits into cash usually received within 3-4 years of project inception.

CASH FLOW ANALYSIS FOR SELECTED PROJECTS

The Congress appears to have intended that the state agencies allocating the tax credits limit the amounts awarded when other subsidies made the project feasible with less than the maximum eligible amount of credits. However, some developers requested and received from state agencies maximum eligible tax credits. These credits, which when combined with Moderate Rehabilitation Program subsidies, generated substantial cash proceeds.

For the eight projects we reviewed, we have attached pro forma schedules to my prepared statement. These schedules summarize the cash proceeds that developers received. In developing these schedules, we consulted with a variety of individuals recognized for their expertise in project development, real estate finance, and low-income housing tax credits. These experts agree that our schedules provide a fair and reasonable basis for estimating cash proceeds received by the developers.

The eight projects we reviewed included the three projects specifically requested by the Committee--Baltimore Gardens in Las Vegas, Nevada; Sierra Pointe in Clark County, Nevada; and Pebble Creek Apartments in Arlington, Texas. All eight were identified in the HUD Inspector General's report as having received excessive subsidies under the Moderate Rehabilitation Program. For instance, on one project the HUD Inspector General identified excessive rental subsidies amounting to about $329,000 annually, which could amount to $4.9 million over the 15 years that these subsidies are to be provided. While we did not attempt to validate the Inspector General's findings, to the extent that excessive or inflated costs are included in the costs associated with project acquisition and development, the cash flows to developers could be somewhat greater than what we have determined. Before proceeding, I would like to thank the HUD Inspector General's office for its cooperation and assistance in our examination.

Regardless of the extent of excessive costs, by combining proceeds from the sales of income tax credits with coinsured mortgage loans secured by moderate rehabilitation rent subsidies, developers were able to generate sizable cash proceeds. Tax credit awards for the eight projects ranged from about $896,000 on one project to about $5.8 million on another. When the developers sold their ownership interests in the projects along with the related tax credits, and these proceeds were combined with mortgage loans and other sources of funds, the developers realized cash proceeds that greatly exceeded costs associated with acquiring and rehabilitating the properties. As I mentioned earlier, we estimate cash flows to developers on the eight projects ranged from about $254,000 for a 36-unit project to about $2.1 million on a 352-unit project. On a per-unit basis, the range was from about $3,500 to about $11,400.

The Committee was particularly interested in how programs intended to benefit low-income persons could generate sufficient cash proceeds to allow developers to pay large consultant fees to obtain HUD moderate rehabilitation subsidies. According to the HUD Inspector General's report, such fees have ranged from $500 to $1,500 per unit. With cash proceeds of $3,500 to more than $11,000 per unit that we have identified, it is evident that developers could afford these consultant fees to secure the moderate rehabilitation subsidies and still receive substantial cash proceeds.

OBSERVATIONS

Mr. Chairman, I would like to point out that neither the Moderate Rehabilitation Program nor tax credits provide developers incentives to minimize costs. In fact, there is an incentive to increase costs. Developers generally receive a fee for rehabilitating a project. This fee is generally a percentage of the rehabilitation costs, thereby providing an incentive to maximize these costs. Similarly, because the amount of tax credits is based on a percentage of rehabilitation and acquisition costs, developers have an incentive to increase expenses, either by inflating costs or incurring unnecessary costs. Without adequate oversight of these costs, the government is vulnerable to providing excessive subsidies. In fact, as I pointed out earlier, HUD's Inspector General found that inadequate HUD oversight contributed to its payment of excessive Moderate Rehabilitation subsidies. Effective management controls are clearly necessary to ensure that reported project costs are valid.

In addition to the need for better management controls within the Moderate Rehabilitation Program, we noted that no overall review of total benefits awarded to a project is presently required by HUD, state tax credit allocation agencies, and, where applicable, local government units. With no centralized oversight of the total "benefit package" provided to individual projects, there is a real opportunity for excessive benefits. Pending legislation now before the Senate Finance Committee would expand the number of projects eligible for tax credits. It would also require state tax credit allocating agencies to adopt plans allocating available credits among eligible projects. Along with other changes, it targets credits to projects serving those with the lowest incomes. It would also direct credits toward projects that produce the most units for the lowest tax credit expenditure. Finally, housing credit agencies would evaluate each project and only provide the amount of credits actually needed to ensure project feasibility over a lenghtened 30-year term. We agree that there is clearly a need for a centralized reviewing authority, and we are evaluating the merits of whether this authority should be placed within the states or HUD. In either case, this authority would help to ensure that limited federal funds are used to maximize the number of low-income housing units.

- - - -

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or Members of the Committee may have.

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS
PROJECT 1

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$5,811,300	
(B)	Tax Credit Proceeds (1)	2,174,623	
(C)	Other	174,647	
(D)	Owners Cash Investment (2)	14,690	
(E)	Total Sources of Funds		$8,175,260
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$2,464,500	
(G)	Development Costs (from HUD 2331A)	3,867,312	
(H)	Developers Fee (3)	773,462	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	87,170	
(J)	Gross Total Applications	7,192,444	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(348,139)	
(L)	Net Total Applications of Funds		$6,844,305
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$2,089,727
(N)	Estimated Proceeds To Developer Per Unit (202 Units)		10,345

---

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
(A) Syndication proceeds equal 45% of awarded credits
(B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
Actual tax credits awarded were $5,369,440

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $350,322 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 2

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$7,401,300	
(B)	Tax Credit Proceeds (1)	2,344,286	
(C)	Other	0	
(D)	Owners Cash Investment (2)	54	
(E)	Total Sources of Funds		$9,745,640
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$3,700,000	
(G)	Development Costs (from HUD 2331A)	4,497,415	
(H)	Developers Fee (3)	899,483	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	111,020	
(J)	Gross Total Applications	9,207,918	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(383,855)	
(L)	Net Total Applications of Funds		$8,824,063
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$1,821,006
(N)	Estimated Proceeds To Developer Per Unit (160 Units)		11,381

---

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
(A) Syndication proceeds equal 45% of awarded credits
(B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
Actual tax credits awarded were $5,788,360

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $445,182 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 3

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$1,214,100	
(B)	Tax Credit Proceeds (1)	362,941	
(C)	Other	0	
(D)	Owners Cash Investment (2)	60,937	
(E)	Total Sources of Funds		$1,637,978
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$680,000	
(G)	Development Costs (from HUD 2331A)	686,862	
(H)	Developers Fee (3)	137,372	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	18,212	
(J)	Gross Total Applications	1,522,446	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(61,773)	
(L)	Net Total Applications of Funds		$1,460,673
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$253,740
(N)	Estimated Proceeds To Developer Per Unit (36 Units)		7,048

---

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103.
Assumptions regarding value of tax credits as follows:
  (A) Syndication proceeds equal 45% of awarded credits
  (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
  Actual tax credits awarded were $896,150

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $72,000 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATION OF FUNDS

PROJECT 4

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$6,549,000	
(B)	Tax Credit Proceeds (1)	2,078,602	
(C)	Other	0	
(D)	Owners Cash Investment (2)	45,882	
(E)	Total Sources of Funds		$8,673,484
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$2,900,000	
(G)	Development Costs (from HUD 2331A)	4,021,947	
(H)	Developers Fee (3)	804,389	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	98,235	
(J)	Gross Total Applications	7,824,571	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(363,020)	
(L)	Net Total Applications of Funds		$7,461,551
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$1,970,440
(N)	Estimated Proceeds To Developer Per Unit (209 Units)		9,428

---

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103.
Assumptions regarding value of tax credits as follows:
  (A) Syndication proceeds equal 45% of awarded credits
  (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
  Actual tax credits awarded were $5,132,350

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $392,940 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 5

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$4,181,100	
(B)	Tax Credit Proceeds (1)	544,834	
(C)	Other	200,782	
(D)	Owners Cash Investment (2)	80,569	
(E)	Total Sources of Funds		$5,007,285
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$2,457,000	
(G)	Development Costs (from HUD 2331A)	2,165,471	
(H)	Developers Fee (3)	433,094	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	62,717	
(J)	Gross Total Applications	5,118,282	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(193,043)	
(L)	Net Total Applications of Funds		$4,925,239
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$434,571
(N)	Estimated Proceeds To Developer Per Unit (122 Units)		3,562

---

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103.
Assumptions regarding value of tax credits as follows:
(A) Syndication proceeds equal 45% of awarded credits
(B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
Actual tax credits awarded were $1,345,270

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $269,634 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 6

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$5,975,000	
(B)	Tax Credit Proceeds (1)	1,362,404	
(C)	Other	33,003	
(D)	Owners Cash Investment (2)	248,361	
(E)	Total Sources of Funds		$7,618,768
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$3,715,000	
(G)	Development Costs (from HUD 2331A)	2,747,754	
(H)	Developers Fee (3)	549,551	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	89,625	
(J)	Gross Total Applications	7,101,930	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(242,998)	
(L)	Net Total Applications of Funds		$6,858,932
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$1,061,026
(N)	Estimated Proceeds To Developer Per Unit (166 Units)		6,392

---

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103.
Assumptions regarding value of tax credits as follows:
(A) Syndication proceeds equal 45% of awarded credits
(B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
Actual tax credits awarded were $3,363,960

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $361,500 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 7

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$8,097,900	
(B)	Tax Credit Proceeds (1)	2,358,437	
(C)	Other	436,170	
(D)	Owners Cash Investment (2)	85,688	
(E)	Total Sources of Funds		$10,978,195
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$4,000,000	
(G)	Development Costs (from HUD 2331A)	5,121,087	
(H)	Developers Fee (3)	512,109	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	121,469	
(J)	Gross Total Applications	9,754,665	
(K)	Less: BSPPA (from HUD Form 2331A) (4)	(453,012)	
(L)	Net Total Applications of Funds		$9,301,653
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$2,102,963
(N)	Estimated Proceeds To Developer Per Unit (352 Units)		5,974

---

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
   (A) Syndication proceeds equal 45% of awarded credits
   (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
   Actual tax credits awarded were $5,823,300

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $487,782 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATE CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 8

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$5,730,200	
(B)	Tax Credit Proceeds (1)	1,996,747	
(C)	Other	354,114	
(D)	Owners Cash Investment (2)	169,766	
(E)	Total Sources of Funds		$8,250,827
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$2,559,700	
(G)	Development Costs (from HUD 2331A)	4,060,607	
(H)	Developers Fee (3)	812,121	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	85,953	
(J)	Gross Total Applications	7,518,381	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(358,105)	
(L)	Net Total Applications of Funds		$7,160,276
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$1,732,906
(N)	Estimated Proceeds To Developer Per Unit (207 Units)		8,372

---

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
   (A) Syndication proceeds equal 45% of awarded credits
   (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
   Actual tax credits awarded were $4,930,240

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $347,850 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

Senator **Graham**. Senator Sarbanes.

Senator **Sarbanes**. If I understand this, in effect, the U.S. Government either through a mortgage loan or the tax credit proceeds put up roughly $8,600,000 for this project to build these 209 units.

Is that correct?

Mr. **Ols**. I think it would only be for the tax proceeds.

Senator **Sarbanes**. They insure the mortgate. If it went under or went belly up, then they would get involved in that. Correct me in the record if I am wrong, but I believe if we just deal with that top half, it's the cash credit benefit.

Mr. **Greene**. Your question is: What's the total amount of public benefits that were provided to this project?

Senator **Sarbanes**. Yes, $8,600,000.

Mr. **Greene**. Because the private mortgage loan is government-insured, it would be roughly this amount here less whatever the cash investment is.

Senator **Sarbanes**. That comes to $8,600,000, of which the developer is going to keep out of that $2 million.

Is that right?

Mr. **Ols**. That's right.

Senator **Sarbanes**. OK.

Senator **Graham**. Mr. Ols, this analysis that you have done brings us up to the completion of construction. That is, if the developer had sold the project on the day that it was complete, this is what the financial statement would have looked like.

Is that correct?

Mr. **Ols**. That's right.

Senator **Graham**. Have you done any cash flow analysis of what might occur over the 15 years of operation of this project with the guaranteed rent?

Mr. **Ols**. No, we have not. Not at this time.

Senator **Graham**. Assumedly, that analysis would indicate that there will be some additional ongoing profitability as a result of operating this unit.

Is that correct?

Mr. **Ols**. Yes.

Senator **Graham**. Then, at the end of the 15-year period, when the rent agreement with HUD expired, the developer would then have a project that would be available for use in the unrestrained market.

Is that correct?

Mr. **Ols**. That is correct.

Senator **Graham**. We've been joined by Senator Heinz.

Senator, do you have any opening statement?

Senator **Heinz**. Mr. Chairman, I think the discussion the committee is having is quite illuminating and very valuable and I don't wish to interrupt it with an opening statement.

Senator **Graham**. It shall be included.

Senator **Heinz**. Mr. Chairman, I would like to ask a more general question of Mr. Adams and Mr. Ols. If it's been asked before, I apologize. I was over on the floor trying to get recognition to offer an amendment along with many other colleagues who have been trying to do so for days to the Defense Department Authorization Bill.

But, my question is, clearly, there were a variety of incentives, most of them operating against good public policy goals, such as efficiency, economy, building at least cost to serve the most needy.

The analysis that's provided here by the GAO, Mr. Ols, is an excellent example of how things can go awry. It is also clear that when the word got out to housing authorities that the way to get involved in one of these kinds of deals was to hook up with, shall we say, a specialized consultant and that many of them proceeded to do so and got hooked, they saw that the only way to success was through certain portals.

And, eventually, some of them decided to walk through. I don't know what it says about my own State of Pennsylvania, but we were elected to walk on section 8 Mod Rehab, for example. We were basically cut out of the program.

I guess that proves it's a bad idea to be both poor and honest. I'm not so sure that we were stupid.

But, my question is, and I suppose I should direct it to Mr. Adams, the inspector general at HUD, in terms of HUD's approach to looking at the programs it was administering and trying to meet a very basic criterion that all of us try and apply in Government, which is are we good shepherds? Are we good stewards of public resources—that would seem to be a question that was never asked.

And my question is: What was there about the system at HUD that avoided what ought to be a periodic and constant question that anybody in public service ought to ask, from being asked?

Mr. **Ols**. That is a very significant question.

Senator **Heinz**. It really has to do with what in business school they might call corporate culture. It might have to do with lack of systems. It might have to do with lack of accountability. It might have to do with personalities. It might have to do with whether or not the inspector general was as on the ball as he is today.

I don't know what it has to do with, but it's not philosophical.

Senator **Graham**. I'd like to ask if Mr. Ols and Mr. Adams would like to comment on that. We're in the midst of a live quorum. And when you conclude your answer to that question, we're going to have to take another recess to vote.

Mr. **Adams**. I will attempt to answer Mr. Heinz' question.

Senator **Graham**. Mr. Adams.

WAIVER OF THE FAIR SHARE PROCESS

Mr. **Adams**. I'm going to try to answer Mr. Heinz' question. Those are some of the same questions we were trying to answer, Mr. Heinz, asked when we were doing our audit work.

One of the problems we ran into or discovered was the waiver of the fair share process and all the decisions became discretionary and there was no accountability. That's one of the things we highlighted in our report.

Senator **Heinz**. I can't accept that. There were people in positions making decisions. To say simply waiving the fair share rule was to relieve people of accountability for making good decisions I can't accept.

Mr. **Adams**. Let me clarify that then. Maybe a better choice of words would be that when we looked, we found no documentation of the decisions that were being made so that we could hold people accountable.

The second part of that is, as Mr. Ols has pointed out in his charts, the moneys taken out by the developer, we found that there was no system by which any group came together to look at the total benefits that were being provided to those projects.

So I don't think anyone ever focused on the total public moneys going in to the Department. The Department did not consider the tax credits and these computations on the subsidies to go to the project.

Senator HEINZ. That's because they weren't accounted for in the HUD budget, or they just didn't give a darn?

Mr. ADAMS. they didn't feel it was part of their responsibility.

Mr. OLS. I might add that the inspector general has stated that is one of the problems because you are not taking both sides of the tax credit State by State; what HUD looks at when they approve the Mod Rehab project; no one looks at the two together. Then you see the scenario being played out on the chart.

If you don't do that, then you are missing a big part of that. And as you can see, the tax credits are a big part of this analysis which makes it very fruitful.

Senator HEINZ. I assume, in your opening statement, you made some specific suggestions as to what ought to be done. Could you just repeat those for the record?

Mr. OLS. Basically, Senator, what we are advocating when I conclude the rest of the prepared statement, basically, we are talking about an oversight of both programs so that, in fact, you can use them in the most efficient manner, the dollars, to fund low income housing.

Senator HEINZ. How should the oversight of that be organized?

Mr. OLS. We are continuing that as part of our examination. I know there's legislation on the Hill I think that would give it mostly to the States, if I recall. It's S.980. We're looking at, should it be at the State level? Should it be at the HUD level and it could be regonal or at headquarters? Or should we have both working together to do that?

We're not at that point to give you an affirmative answer right now.

Senator HEINZ. Thank you very much.

Senator SARBANES. Mr. Chairman, might I ask about the exhibit that is before us?

Senator GRAHAM. Senator Sarbanes.

Senator SARBANES. I have been doing some calculations here. There's 209 units. I take it, there were about $41,500 per unit.

Is that correct?

Mr. OLS. For costs?

Senator SARBANES. Yes.

Mr. OLS. I don't have that right in front of me. But that's probably correct.

Senator SARBANES. Is it a legitimate calculation to divide 209 into the $8,673,000?

Mr. GREENE. Senator, it would be a better calculation to divide 209 units by the development cost. The $8 million would also include the acquisition costs for the property.

If you look totally at the rehab portion of it, it would be the 209 divided by the development costs.

Senator **Sarbanes**. Let me put it this way. Of the money coming in to this project for the source of funds, you've got $8,673,000 coming in for 209 units.

So that would be $41,500 per unit flowing in.

Now, when the developer pulled $2 million out of this, as I calculate, that's equivalent to 47 units. I mean, the developer's entitled to get something, I realize, but I mean, in effect, if you'd had a nonprofit developer in this instance who would use all of the money coming in to build units, you could have had another 47 units for low income people.

Is that right?

Mr. **Ols**. That is probably right. As a matter of fact, in another chart I was going to show you, it would be a hypothetical case to show you how many more units you could rehab. In this case, I think it might come out to be 47. I just haven't worked it out that way.

I'll be glad to calculate that, obviously, in our figures and our analysis, to see and provide for the record what that would really come out to.

Calculation of additional units for project 4

Total developer proceeds	$1,970,440
Divided by total proceeds per unit	41,500
Additional units that could have been funded ($1,970,440 ÷ $41,500)	47

Senator **Sarbanes**. Where was this project?

Mr. **Ols**. This project was in Denver, CO.

Senator **Sarbanes**. Do you know who the developers were?

Mr. **Ols**. The Winn Group.

Senator **Sarbanes**. That's the group that had all those former HUD officials in it. Is that correct?

Mr. **Ols**. Yes, Senator.

Senator **Sarbanes**. Is that Abrams, the former Undersecretary of HUD? And Winn, the former Assistant Secretary?

Mr. **Ols**. Yes, that is.

Senator **Sarbanes**. They knew these tax credits were there.

Mr. **Ols**. Can I respond to that?

I would agree with you, that is what makes this very lucrative is people that knew how the system worked, take the combination of the rent subsidies of the fair market rent values, the tax credit system and go out and merge those two programs together or three programs together and coinsurance on top of that, and a guaranteed loan.

Senator **Sarbanes**. But the bottom line is not only that they made a lot of money, but in the course of doing that, they deprived people in need of housing of the opportunity to get housing. This is a dramatic instance of it because if they hadn't been raking it off this way, we could have built more units for people in desperate need of housing.

Mr. **Ols**. I agree.

Senator GRAHAM. I think what Senator Sarbanes has indicated is that, in some of the earlier hearings that have been held, we've identified the rat. Now we're starting to identify the cheese that attracted those rats. [Laughter.]

Senator GRAHAM. Let me ask about another part of that cheese.

When was project No. 4 built? What time?

Mr. OLS. It was placed in service in 1987.

Senator GRAHAM. You say it was in Denver, CO?

Mr. OLS. Yes, it was.

Senator GRAHAM. As I know Denver in 1987, that was a relatively depressed housing market.

Is that correct?

Mr. OLS. Yes.

Senator GRAHAM. I assume that meant that there were a substantial number of vacancies in the housing market in Denver in 1987?

Mr. OLS. It would be probably the same as today. They have a lot of vacancies.

Senator GRAHAM. The purpose of this program was to provide housing for low income families who might otherwise have been unable to secure housing. That is, without the kind of subsidies this made available.

Is that the original purpose of this program?

Mr. OLS. That's correct. I think this program was to provide additional housing for low income families.

Senator GRAHAM. It strikes me as questionable as to whether applying the limited number of units that were available per year in this program, and I think we had testimony that there were only 5,000 units a year.

Is that right? That 209 of those units would go into a community that already was suffering not from inadequate, but from excess capacity.

Was there any reason why the developer should have picked a community like Denver as the place in which to engage in this activity?

WHY DENVER?

Mr. OLS. I would say yes in regards to the acquisition costs, the land value probably was much lower there. And that's one of the key things that makes it work if your tax credits are based on your development costs. You can throw more money into your development of the project and you didn't have to pay much for the land to jack up your equivalent tax credits that you're going to calculate for the cost of this dollar for dollar basis.

If you went and paid a lot of money for land, that would mess up your whole cash flow situation. That would be my opinion.

Mr. ADAMS. Could I comment on that, Mr. Graham?

I think there's an additional incentive also because the market rents lag, and we have a period when established fair market rents are still very high because it's not yet turned down.

So, the fair market rents are very high at that point. Also still, although the economy is depressed, and they're not keeping pace with each other.

Senator **Graham**. So, to summarize, if you said that this set of incentives further skewed the program toward those areas of the country that may have been least in need of additional housing because of an already depressed situation, because by going into those communities, developers were able to minimize their land acquisition costs, thereby maximizing the proportion of their expenditures on development, which is the segment of expenditures that generated the low income tax credits.

And, second, to get additionally excessive rental allowances because those rental allowances were based on relationships that may have dated from a boom period when they were higher and had not yet caught up to the impacts of the recession.

Mr. **Adams**. True. There's a third item also and that is probably the availability of tax credits in that area also that might not be present otherwise.

Senator **Graham**. Because of the limited activity, there was not the competition for tax credits?

Mr. **Adams**. Correct.

Senator **Graham**. Was this just an unusual situation? Project? For picking out a community that seemed to be especially ripe for plundering? Or was there a pattern of locating these moderate rehabilitation projects in communities that had the economic characteristics of Denver?

Mr. **Ols**. Paul can answer that. I know, in his statement, he has a chart that shows that.

Mr. **Adams**. We cover that in one of these statements, or one of the charts that we have displays that graphically in the four States of Nevada, Oklahoma, Colorado, and Wyoming.

Dr. **Schussheim**. Mr. Chairman, in my look at this question, we examined 20 projects that had coinsured section 8 fund rehabs. Thirteen were clearly in very real weak rental market areas. The areas that I list are: Denver, CO; Casper, WY; Tulsa, OK; the Oklahoma City area; Arlington, TX, which is the Fort Worth area; Salt Lake City and Columbia, SC.

In addition, Dade County, which got one of these projects on my list, was apparently overbuilt at that time. They had a relatively high vacancy rate.

I can find six projects that were located in strong or moderately strong market areas, and I have Washington, DC; Charlotte, Gastonia, NC; Baltimore area, and I include Las Vegas, which, by my indicators, was fairly strong.

Senator **Graham**. We have another vote underway. I'd like to ask if Mr. Ols could conclude his prepared testimony. Then we'll vote and return with Mr. Adams and Mr. Schussheim and proceed to questions for all the panelists.

I'm going to be particularly interested in Mr. Terner and Ms. Truett's comments on the cash flow analysis that's been presented, and how they, as a developer and a local housing authority official would view this.

Mr. Ols.

Mr. **Ols**. Yes, Mr. Chairman, if I could add, you know, I've already talked about what I thought was needed in oversight and so forth.

Maybe, if Dennis or Rick could help me out, I'll show you one more chart, which I think shows you what we referred to as the "hurt" on the project.

Maybe what I'll do is I'll let Dennis just walk you through it real quick. We'll leave it up here. If there's more questions when you return, we would be glad to answer those at that time.

It's a hypothetical case that I think we show what happens. And it just gets back to Senator Sarbanes' comment: What effect does it have on the money that's going to go into other assistance, other units, or other people—helping them get housing?

Senator **GRAHAM**. Excuse me for interrupting again, Mr. Ols, but I want to announce that the vote on the recommendation of the nomination of Mr. Kloske and Ms. Fitts, both nominations will be reported with a favorable 17 yeas and zero nays.

Senator **SARBANES**. Mr. Chairman, may I ask just one question? Are there some State agencies, in allocating the tax credits, that screen out whether they're also getting the loans?

Mr. **ADAMS**. We have no information on that. I think earlier testimony by the earlier two witnesses indicate that there's various functions in various States which we are not familiar with.

Mr. **FRICKE**. Can I just go over this very briefly on what the chart is going to demonstrate?

GAO

Example of How a Break Even Rent Level Is Calculated

Rehabilitation of an Apartment (Cost Based on 800 Square Foot Unit)		**Yearly Tax Credit**
Land Cost	$ 2,000	$ 0
Acquisition Cost — Less Land	20,000	800
Rehabilitation Cost	20,000	1,800
Soft Costs — Including Financing Costs, Architectural Fees, Engineering Fees, Insurance and Taxes, and Sponsor's Administrative Expenses	13,000	1,170
		$3,770
		Cash from Tax Credit
Total Cost	$55,000	$15,269
		Rent Needed When Tax Credits Used
Operating Expenses — Yearly Rent Needed (Annual Estimated Based on 800 Square Foot Unit)		
Capital Repayment @ 10%, 30 Years	$5,792	$4,184
Taxes and Insurance	1,043	1,043
Management, Maintenance, Repairs Utilities	1,043	1,043
Utilities	724	724
Total Annual Expense	$8,601	$6,994
Minimum Monthly Rent Required To Cover Operating Expenses	$717	$583
Potential Monthly Saving of Rental Subsidy Funds		$134

At this time, we have cost to rehabilitate an 800 square unit, we come down to the bottom line here in which we say it cost $55,000. You amortize the $55,000 loan over 30 years at 10 percent. It costs $5,792. The other costs I'm associating with the annual operating expenses—taxes and insurance, utilities, maintenance. The total cost to operate this unit: $8,601 a year.

This would equate to a $717 a month rent over the 12 months. We will come back to the $8,601.

This is the kind of program we have you might think of, as how the Mod Rehab is designed to work.

Here we bring in tax credits. There's no tax credits for land. There's an acquisition cost less land, there's a rehabilitation cost, there's a cost of financing, bringing the total tax cost annual to $3,770. Over a 10-year period, that's $37,000. We made certain assumptions that were laid out in our schedules on our tax statement.

The actual present value to the tax credit on issue is worth about $15,000. If the developer put that tax credit back into this unit. It reduces the development and acquisition costs. He would bring this $55,000 roughly to somewhere around $40,000. To amoritize the $40,000 loan over 30 years at 10 percent comes down to $4,184. A substantial difference.

All the other costs associated with operating the taxes, the utilities, will all remain the same. You come down to a bottom line of $6,994, what it would cost to operate that unit per year as opposed to $8,601.

The monthly rental payment, instead of being $717, would be $583, a difference of $134 between the additional subsidy, instead of flowing back to the project which could be used to subsidize the rents of other low income people.

In terms of how many units, the question has been asked in terms of how many units could be supported with this tax, how many low income people, I should say, could be supported with this tax credit: $15,269. It really ranges, depending on the income of a low income person, the higher that income the more low-income people could be supported because the Government subsidy is not as high. The lower the income of the person, the greater the subsidy.

Assume in this case that the income of the person was $20,000, which may be what it would be in this area. Then, $20,000, these calculations, without going into them, would support about another 1½ people, or $15,000. We could do another 100 units for $1 million in tax subsidies.

I'll try to answer any questions you may have when you return from recess.

Senator **Sarbanes**. If this tax credit is $2 million produced by the project had all gone back into it, you could have doubled the number of units.

Is that correct?

Mr. **Dennis**. That's correct, sir.

Senator **Sarbanes**. Instead of 209 units, you could have had about 400 units?

Mr. **Dennis**. Using our assumptions of what the cost to rehabilitate the unit was, which are I think reasonable, and I think, if you assume a unit, a tenant income of approximately $20,000, that's correct.

Senator **Graham**. The meeting will recess. We'll reconvene upon the conclusion of this vote.

[Recess.]

Senator **Graham**. The meeting will come to order.

Mr. Ols, as we broke for that vote, you had just finished presenting your estimated cash flow chart. If you have no further comments on that, I'd like to turn to the other two members of the panel for their opening statements and then we will discuss all the information that will be before the committee as a block—or blob.

Do you have any further comment, Mr. Ols?

Mr. **Ols**. No, not at this time.

Senator **Graham**. Mr. Adams, the inspector general for the Department of HUD.

STATEMENT OF PAUL A. ADAMS, INSPECTOR GENERAL, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC

Mr. **Adams**. Thank you, Mr. Chairman.

With your permission, I also would like to submit my statement for the record and try to summarize it as briefly as possible.

On May 17 of this year, we appeared here to provide an overview of the problems noted in our reports issued in April of this year. Those hearings focused a great deal on the use of consultants. Their role in the program. At that time, Chairman Riegle asked us to try to identify all the consultants participating in the program and their fees.

In addition, we were requested to analyze further some of our data focusing on the actual use of the funding.

Today, I'll try to focus on three areas: The use of consultants, the fair share allocation problems and the extensive subsidies in Mod Rehab projects.

When we issued our report in April, we identified some $4.2 million in consultant payments. The payments were made to 12 different individuals and covered 27 projects.

At the chairman's request, we performed additional work to determine the extent to which consultants were used. We obtained data from public housing authorities concerning some 270 projects funded since October 1983. We then contacted the developers of those projects to obtain data about their use of consultants.

As listed in tab one to my statement, our data now shows 20 different consultants were paid in excess of $5.7 million for lobbying services on 51 projects.

This represents our identification of eight additional consultants and additional payments for four consultants not originally identified.

During our survey, five developers informed us that because of all of the recent media attention, some bills were not paid in full, thus the amounts for three consultants actually decreased from our April base.

It is interesting to note that 51 projects for which consultants were paid covered some 7,268 units or about 20 percent of all units funded since October 1983.

As concerns the fair allocation situation, for many years, assisted housing funds were allocated by HUD in accordance with a formula-driven allocation process that involved census, housing survey and economic data, analyzed to mathematically distribute the housing funds based on the need.

During most of the other period, Congress waived HUD's request requirements for fair share calculations. In some cases, HUD chose to fair share in a modified way by sending funds to previous levels based on the former years.

However, the Mod Rehab Program was not fair shared in any manner, but allocated by headquarters and directed to public housing authorities.

We've prepared charts showing the impact of the headquarters discretionary selection process to highlight what some States received in this process. That's also attached to my statement as well; it's on the stand at the present time.

The two pie charts list the 10 States receiving the most and the least disporportionate shares: Florida got the most, California got the least.

It should also be noted that Florida also led in the number of projects, 15, where developers paid consultants.

As a matter of fact, 45 of the 51 projects where developers paid consultants fall in States that received the most. For instance, Puerto Rico and Massachusetts both had eight projects where developers paid consultants.

Another key point that led us to believe that merit didn't play an important part in the selection process is that many former HUD officials had an owership part in the projects funded.

As I said before, these projects seemed to be concentrated in Colorado, Oklahoma, Nevada, and Wyoming, which always received more funds than they would have under the fair share process.

Another key finding of our audit was that the use of HUD coinsured financing and low-income housing tax credit said that the costs increased substantially. This is especially true when we analyze the way this expensive program was funded in relation to the economies of those locations.

As part of our overall review, judging from 14 projects which were coinsured by mortgage companies which originated 44 HUD project loans as of November 30, 1988, our audit found problems with all 14.

We estimated that mortgages for the 14 projects were excessive by $22 million; moreover, section 8 subsidies were excessive by some $37 million over the 15-year contract term of these projects.

While the lender was primarily responsible for the problems, our report also criticizes HUD guidance and oversight when the Mod Rehab and Coinsurance Programs were combined.

The basic problem with it in this audit was that rents were established at artificially high levels in relations to actual rent levels in the project locations.

We estimated that in over 70 percent of the cases, rents were set at or very near the maximum rents allowed. Further analysis of the data we obtained during our audit combined with data obtained from local housing authorities demonstrates further the uneconomical use of section 8 funds. We prepared a map depicting the geographical distibution of the 44 pojects coinsured in November 1988. For each location, we determined the difference between actual Mod Rehab Program rents and the section 8 Existing Program rents as a percentage of fair market rents.

The basic premise of the Mod Rehab Program was to provide the owner the 20 percent premium over the section 8 existing rent paid for upgrading the rental units.

Thus, we believe any differences exceeding 20 percent of the fair market rent indicate a potential problem rent. The map shows that seven projects were under 20 percent, and the remaining 37 projects exceeded 20 percent.

We also prepared charts comparing section 8 Mod Rehab rents for rentals in other market areas. These charts show the four States where the Mod Rehab rents were concentrated; the bar graph displays the differences between the actual Mod Rehab rents and other program data. While the Mod Rehab rents are high, other subsidized housing in those areas would be much less expensive.

For example, in Oklahoma, the actual Mod Rehab rents exceeded actual existing rents by 40 percent. Meanwhile, even the fair market rents for new and substantial rehab units are about 20 percent lower than the actual Mod Rehab project rents.

The bottom line is that the Mod Rehab Program probably was not needed in these States during this period of time.

A few moments earlier, I mentioned a possible connection between former HUD employees and project selection. It should be noted that in the 23 projects concentrated in Oklahoma, Colorado, Wyoming, and Nevada, one or more former HUD officials were involved in every project as an officer or consultant or mortgage broker.

Our last point concerns the use of low-income housing tax credits in the Mod Rehab Program. We believe the tax credits were designed to produce additional low-income housing units. Our review of several projects showed that the tax credits were not used to reduce rents, thereby resulting in excessive subsidies. Rather, the tax credits generally provided a much higher return to the developer on the section 8 Mod Rehab project units.

Since these units probably would have been brought on line anyway, the use of tax credits in these projects produced no additional low-income units.

That concludes my remarks, Mr. Chairman. I'll be glad to respond to any questions.

[The complete prepared statement of Paul A. Adams follows:]

Statement of
Paul A. Adams, Inspector General
Department of Housing and Urban Development
Accompanied by Chris Greer, Assistant Inspector General for Audit
Before the Committee on Banking, Housing and Urban Affairs
United States Senate
August 2, 1989

Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear before you today to further discuss our review of the Section 8 Moderate Rehabilitation Program (Mod Rehab). Accompanying me today is Chris Greer, Assistant Inspector General for Audit.

On May 17, 1989, we appeared here to provide an overview of problems noted in our audit and investigation reports issued in April 1989. Those hearings focused a great deal on the use of consultants and their role in the Program. At that time, Chairman Riegle asked us to try to identify all consultants participating in the Program and their fees. In addition, we were requested to further analyze some of our data concerning the actual use of scarce Mod Rehab funding.

Before we get into specific details, I would like to highlight and summarize the audit results.

Our audit report pointed out several key factors that led to a perception that the Program was manipulated to favor certain Public Housing Authorities, owners, and developers. For example:

- The selection process violated applicable Mod Rehab regulations, which in turn led to the wholesale use of consultants that lobbied Headquarters officials for funding allocations.
- Many former high level HUD employees participated in the programs as owners, consultants or mortgage brokers.
- Developers often received windfall profits through tax credit syndications.
- The Headquarters selection process resulted in the uneconomical use of Section 8 subsidies.

Mod Rehab was designed to supplement the Section 8 Existing Program by providing funds for modest repairs to units spread throughout a given community. However, we found that it actually was used to fund large scale rehab projects at specific locations within a community. Thus the intended program goals and objectives were not met.

In addition, substantial amounts of funds were wasted. We estimated that potential excess subsidy payments could exceed 413 million dollars over the 15-year contract terms for the 35,700 units funded since 1984. We also concluded that any low-income housing tax credits allocated to these projects will be wasted since HUD has no policy regarding tax credit application in calculating Mod Rehab rents, resulting in double subsidies.

With that brief background, we would like to focus on three areas: (1) the use of consultants, (2) fair-share allocation problems, and (3) excessive subsidies at many Mod Rehab projects.

Use of Consultants

In conducting our audit, we reviewed 43 projects at 20 Public Housing Authorities in detail. We also reviewed about 30 other projects regarding the manner in which the Public Housing Authority selected the developers to participate in the Program. When we issued our audit and investigation reports in April, we had identified over 4.2 million dollars in consultant payments. The payments were made to 12 different individuals and covered 27 projects.

At the Chairman's request, we performed additional work to determine the extent to which consultants were used. We obtained data from Public Housing Authorities concerning about 270 projects funded since October 1983. We then contacted the developers of those projects by phone to obtain data about their use of consultants.

As listed on Attachment 1 to our statement, our data now shows that 20 different consultants were paid in excess of 5.7 million dollars for lobbying services on 51 projects. This represents the identification of 8 additional consultants and additional payments for 4 of the consultants originally identified.

During our survey, five developers informed us that because of all the recent media attention some billings were not paid in full. Thus the amounts for 3 consultants actually decreased from our April data.

The data also shows that consultant payments for the 51 projects covered 7,268 units or about 20.3 percent of all units funded since October 1983.

Fair Share Allocation Problems

For many years, assisted housing funds were allocated by HUD in accordance with a formula driven fair-share allocation process. Census data, housing survey data, and economic data were analyzed to mathematically distribute available housing funds based on needs.

During most of the audit period, Congress waived, at HUD's request, the requirement to fair-share housing funds. In some cases, HUD chose to fair-share funds in a modified way by sending funds to the Regional level based on the formula. However, the Mod Rehab Program was not fair-shared in any manner but allocated by Headquarters directly to the Public Housing Authority. We have prepared charts showing the impact of the Headquarters discretionary selection process to highlight what some States received using this process versus what they would have received under fair-share. Attachment 2 contains the data.

The two pie charts list the 10 States receiving the most and the least disproportionate shares. Florida got the most and California got the least. It should also be noted that Florida also led in the number of projects (15) where developers paid consultants. As a matter of fact, 45 of the 51 projects where developers paid consultants fall in States on the most side. Puerto Rico and Massachusetts both had 8 projects where developers paid consultants.

Another key point that led us to conclude that favoritism played an important part in project selection was ownership interest in many projects by former HUD officials. As we will discuss later, their projects seem to be

concentrated in Colorado, Oklahoma, Nevada, and Wyoming, which all received more funds than they would have with fair-share in effect.

Although Headquarters discretion for funding a small percentage of units each year can be an effective tool for meeting emergency or special needs, we believe HUD's total use of discretionary funding during the audit period ignored emergency or special needs.

Excessive Subsidies at Many Mod Rehab Projects

Another key finding of our audit was that the introduction of coinsured HUD financing and low-income housing tax credits caused the Federal cost of the Mod Rehab Program to increase substantially. This is especially true when we analyze where this expensive Program was funded in relation to the economies in those locations.

As part of our overall review, we audited 14 projects that were coinsured by Benton Mortgage Company which originated 44 Mod Rehab project loans as of November 30, 1988. Our audit included 14 loans and found problems with all 14. We estimated that mortgages for the 14 projects were excessive by 22 million dollars or (29 percent). Moreover, Section 8 subsidies will be excessive by 37 million dollars over the 15-year contract terms for these 14 projects. While the lender is primarily responsible for the problems, our report also criticizes HUD's guidance and oversight when the Mod Rehab and Coinsurance Programs were combined.

The basic problem noted in this audit was that rents were established at artificially high levels in relation to actual rent levels in the project locations. We estimated that in over 70 percent of the cases, rents were set at or very near the maximum rents allowed.

Further analysis of the data we obtained during our audit, coupled with some new data obtained from Public Housing Authorities, demonstrates further the uneconomical use of Section 8 funds.

We have prepared a map depicting the geographic distribution of the 44 projects coinsured by Benton at November 1988. For each location, we determined the difference between actual Mod Rehab Program rents and Section 8 Existing Program rents as a percentage of the Fair Market Rents. The basic premise of the Mod Rehab Program was to provide the owner a 20 percent premium over the Section 8 existing rent to pay for upgrading the rental units. Thus, we believe any differences exceeding 20 percent of the Fair Market Rents indicate potential problem rents. A breakdown of the coded symbols on the map shows:

0 -- 19 percent	7 projects
20 -- 29 percent	11 projects
30 -- 39 percent	17 projects
over 40 percent	9 projects

We also prepared charts depicting Section 8 Mod Rehab project rents in relation to other factors in four market areas. These charts show the four States in which coinsured Mod Rehab projects were concentrated. The bar graphs explain the relationship between actual Mod Rehab rents and other HUD program data. While the Mod Rehab rents are high, other indicators show that other subsidized housing in those areas would be much less expensive. For example, in Oklahoma the actual Mod Rehab rents exceed actual existing rents by about 40 percent. Meanwhile, even the Fair Market Rents for new and sub-rehab units are about 20 percent lower than the actual Mod Rehab project rents. The bottom line is that the Mod Rehab Program probably was not needed in these States during this time period.

A few moments earlier, I mentioned a possible connection between former HUD employees and project selection. It should be noted that in the 23 projects concentrated in Oklahoma, Colorado, Wyoming and Nevada, one or more former HUD officials were involved in every project as an owner, consultant or mortgage broker.

Our last point concerns the misuse of low-income housing tax credits in the Mod Rehab Program. We believe the tax credits were designed to produce additional low-income housing units. Our review of several projects showed that tax credits were not used to reduce rents, and thus HUD subsidies. Rather the tax credits generally provided a much higher return to the developers of the Section 8 Mod Rehab project units. Since these units probably would have been brought on-line anyway, the use of tax credits on those projects produced no additional low-income units.

That concludes my written statement, Mr. Chairman. We appreciate your attention and will be pleased to answer any questions.

ATTACHMENT I

SUMMARY OF CONSULTANT PAYMENTS
AT JULY 31, 1989

NAME	AMOUNT AT 4/26/89	AMOUNT AT 7/31/89
Joseph Strauss, Phoenix Associates	$1,305,875	$1,684,875
Michael Karem, Worldwide Consultants	420,000	360,000 1/
Gerald Kisner, Lasaki Mgt Corp.	282,500	282,500
Rick Price	125,149	125,149
R. Carter Sanders	107,000	110,600 2/
Ron Gatton, Redevelopment Services Co.	84,000	70,000 1/
Dan Hughes		145,000
Philip Abrams, Philips Development Co.		100,000
Lynda Murphy, Barrett, Montgomery, Murphy		83,400
Carla Hills		138,445
Edward Brooke	183,000	183,000
Frederick Bush, Bush and Company	260,000	215,000 1/
Louie B. Nunn	375,000	594,000
Judith Siegel, Landex Corp.	351,000	361,000
James Watt	300,000	300,000
Richard Shelby, The Keefe Company	442,000	442,000
Paul Manafort		348,500
Bill Taylor		146,000
Lou Kitchin		25,000
Jerris Leonard		5,000 3/
TOTALS	$4,235,524	$5,719,469

1/ Developers informed us billings were higher but full payments would not be made because of recent publicity.

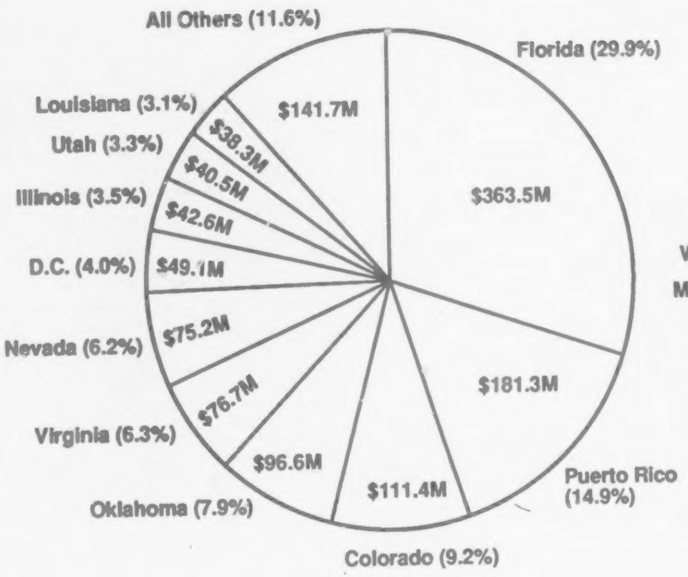
2/ The developer advised us he had no intention of paying an additional $96,000 billed by the consultant.

3/ The developer advised us he has no intention of paying an additional $50,000 billed by the consultant.

ATTACHMENT 2
Page 1 of 3

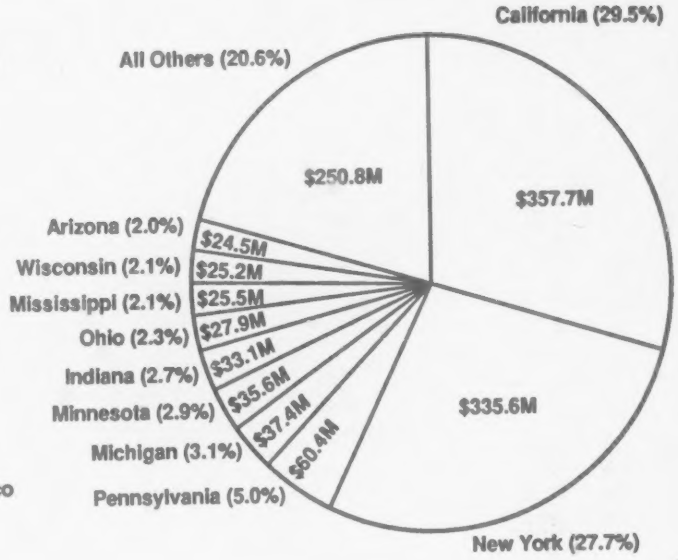
States Allocated More Than Fair Share

Fiscal Years 1984 - 1988



States Allocated Less Than Fair Share

Fiscal Years 1984 - 1988



ATTACHMENT 2
Page 2 of 3

STATES ALLOCATED MORE THAN FAIR SHARE AMOUNT OF FUNDS
FISCAL YEARS 1984 - 1988

					-- OVER-ALLOCATED --		
STATE	PROJECTS WITH CONSULTANTS	PERCENTAGE OF FUNDS ALLOCATED	FAIR SHARE PERCENTAGE	PCT OF FUNDS OVER/(UNDER) FAIR SHARE	CONTRACT AUTHORITY (Millions)	BUDGET AUTHORITY (Millions)	PERCENT OF OVER-ALLOCATED FUNDS
Florida	(15)	15.15%	3.3%	11.85%	$24.2	$363.5	29.9%
Puerto Rico	(8)	6.91	1.0	5.91	12.1	181.3	14.9
Colorado	(1)	4.63	1.0	3.63	7.4	111.4	9.2
Oklahoma		4.05	0.9	3.15	6.4	96.6	7.9
Virginia		4.40	1.9	2.50	5.1	76.7	6.3
Nevada		2.85	0.4	2.45	5.0	75.2	6.2
D.C.		2.30	0.7	1.60	3.3	49.1	4.0
Illinois	(3)	6.49	5.1	1.39	2.8	42.6	3.5
Utah		1.72	0.4	1.32	2.7	40.5	3.3
Louisiana		2.75	1.5	1.25	2.6	38.3	3.1
South Carolina		1.74	0.9	0.84	1.7	25.8	2.1
Maryland	(2)	2.46	1.7	0.76	1.6	23.3	1.9
New Jersey	(2)	4.44	3.7	0.74	1.5	22.7	1.9
Nebraska		1.14	0.5	0.64	1.3	19.6	1.6
Wyoming		0.60	0.2	0.40	0.8	12.3	1.0
Missouri	(2)	1.89	1.5	0.39	0.8	12.0	1.0
Virgin Islands		0.32	0.0	0.32	0.7	9.8	0.8
Massachusetts	(8)	4.18	3.9	0.28	0.6	8.6	0.7
North Dakota	(2)	0.34	0.2	0.14	0.3	4.3	0.4
Vermont	(2)	0.35	0.3	0.05	0.1	1.5	0.1
Montana		0.45	0.4	0.05	0.1	1.5	0.1
Washington		1.61	1.6	0.01	0.0	0.3	0.0
TOTALS	(45)	70.77%	31.1%	39.67%	$81.1	$1,216.9	99.9%

[Rounding may effect accuracy of totals.]

ATTACHMENT 2
Page 3 of 3

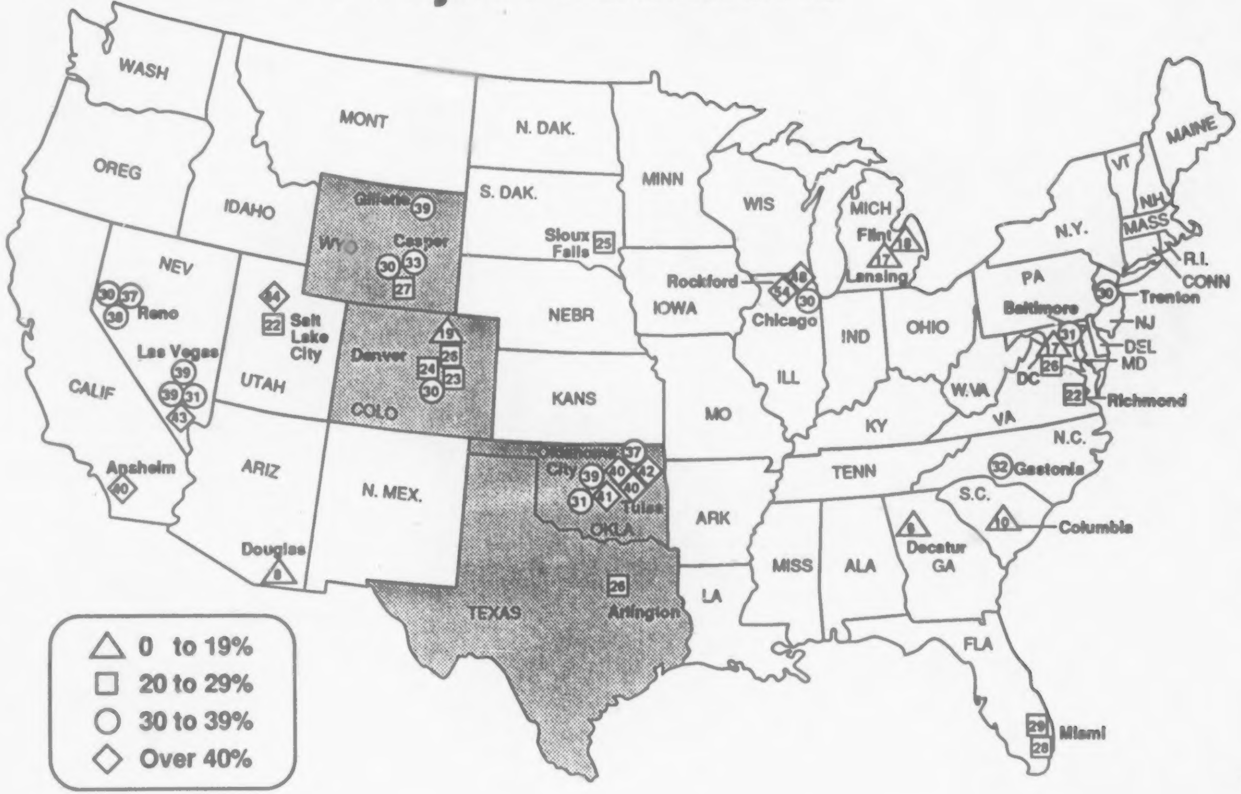
STATES ALLOCATED LESS THAN FAIR SHARE AMOUNT OF FUNDS
FISCAL YEARS 1984 - 1988

STATE	PROJECTS WITH CONSULTANTS	PERCENTAGE OF FUNDS ALLOCATED	FAIR SHARE PERCENTAGE	PCT OF FUNDS OVER/(UNDER) FAIR SHARE	-- UNDER-ALLOCATED -- CONTRACT AUTHORITY (Millions)	-- UNDER-ALLOCATED -- BUDGET AUTHORITY (Millions)	PERCENT OF UNDER-ALLOCATED FUNDS
California		4.94%	16.6%	(11.66)%	$(23.8)	$(357.7)	29.5%
New York		2.66	13.6	(10.94)	(22.4)	(335.6)	27.7
Pennsylvania		1.83	3.8	(1.97)	(4.0)	(60.4)	5.0
Michigan	(2)	1.48	2.7	(1.22)	(2.5)	(37.4)	3.1
Minnesota		0.24	1.4	(1.16)	(2.4)	(35.6)	2.9
Indiana		0.22	1.3	(1.08)	(2.2)	(33.1)	2.7
Ohio		2.29	3.2	(0.91)	(1.9)	(27.9)	2.3
Mississippi		0.27	1.1	(0.83)	(1.7)	(25.5)	2.1
Wisconsin		0.78	1.6	(0.82)	(1.7)	(25.2)	2.1
Arizona		0.20	1.0	(0.80)	(1.6)	(24.5)	2.0
Arkansas			0.8	(0.80)	(1.6)	(24.5)	2.0
Iowa		0.24	1.0	(0.76)	(1.6)	(23.3)	1.9
Kansas			0.7	(0.70)	(1.4)	(21.5)	1.8
Georgia	(1)	1.60	2.2	(0.60)	(1.2)	(18.4)	1.5
North Carolina	(2)	1.35	1.9	(0.55)	(1.1)	(16.9)	1.4
Hawaii		0.08	0.6	(0.52)	(1.1)	(16.0)	1.3
Idaho			0.5	(0.50)	(1.0)	(15.3)	1.3
Kentucky		0.83	1.3	(0.47)	(1.0)	(14.4)	1.2
Connecticut		1.05	1.5	(0.45)	(0.9)	(13.8)	1.1
Rhode Island		0.05	0.5	(0.45)	(0.9)	(13.8)	1.1
New Mexico		0.19	0.5	(0.31)	(0.6)	(9.5)	0.8
Alaska			0.3	(0.30)	(0.6)	(9.2)	0.8
Oregon		0.91	1.2	(0.29)	(0.6)	(8.9)	0.7
Maine		0.37	0.6	(0.23)	(0.5)	(7.1)	0.6
Texas	(1)	4.19	4.4	(0.21)	(0.4)	(6.4)	0.5
West Virginia		0.49	0.7	(0.21)	(0.4)	(6.4)	0.5
Guam			0.2	(0.20)	(0.4)	(6.1)	0.5
Alabama		1.01	1.2	(0.19)	(0.4)	(5.8)	0.5
South Dakota		0.13	0.3	(0.17)	(0.3)	(5.2)	0.4
New Hampshire		0.36	0.5	(0.14)	(0.3)	(4.3)	0.4
Delaware		0.11	0.2	(0.09)	(0.2)	(2.8)	0.2
Tennessee		1.36	1.4	(0.04)	(0.1)	(1.2)	0.1
TOTALS	(6)	29.23%	68.8%	(39.57)%	$(80.8)	$(1,213.7)	100.0%

[Rounding may effect accuracy of totals.]

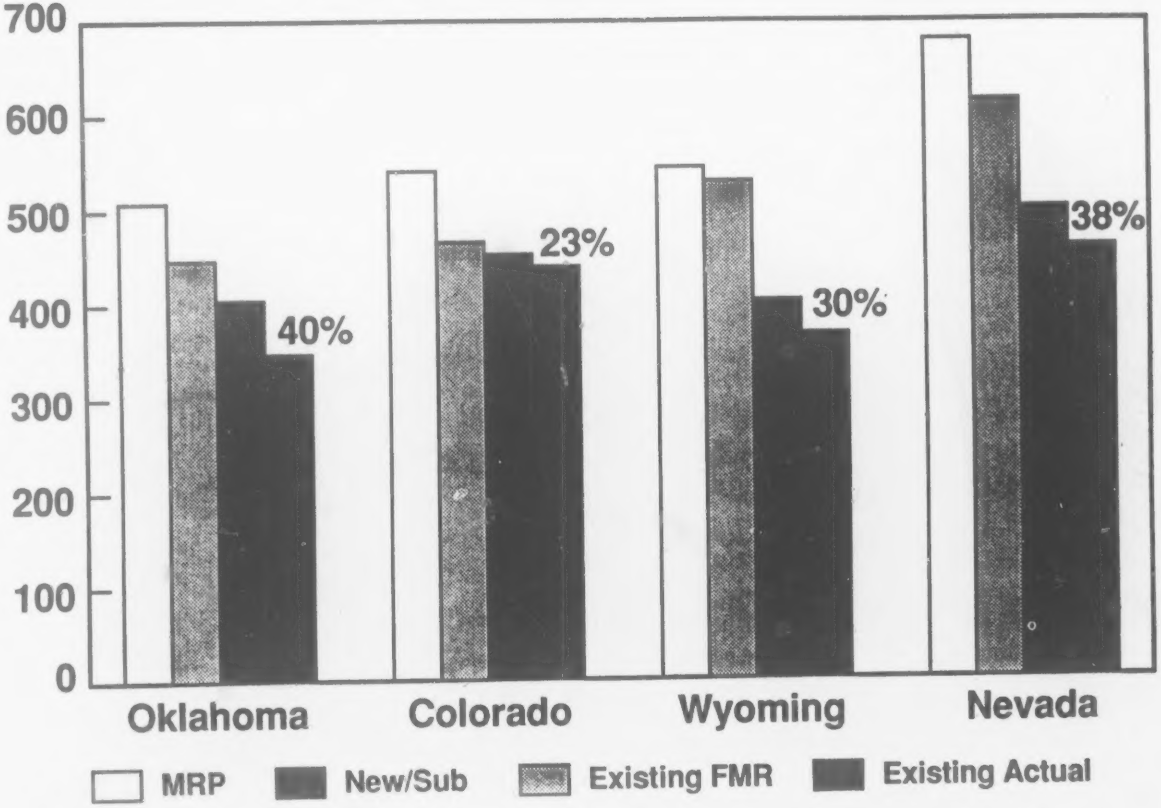
ATTACHMENT 3

Project Locations


WASH
OREG
CALIF
IDAHO
NEV
MONT
WYO
UTAH
ARIZ
COLO
N. MEX.
N. DAK.
S. DAK.
NEBR
KANS
OKLA.
TEXAS
MINN
IOWA
MO
ARK
LA
WIS
ILL
MICH
IND
OHIO
KY
TENN
MISS
ALA
GA
FLA
S.C.
N.C.
VA
W.VA
PA
N.Y.
VT
NH
MAINE
MASS
R.I.
CONN
NJ
DEL
MD
DC
Reno 30 37 38
Las Vegas 39 39 31 43
Anaheim 40
Salt Lake City 44 22
Douglas 8
Gillette 39
Casper 30 33 27
Denver 19 26 24 23 30
Sioux Falls 25
Oklahoma City 37 39 40 42 40 31 41
Tulsa
Arlington 26
Rockford 48 54 30
Chicago
Flint 18
Lansing 17
Baltimore 31 17 26
Trenton 30
Richmond 22
Gastonia 32
Columbia 10
Decatur GA 8
Miami 29 28
△ 0 to 19%
□ 20 to 29%
○ 30 to 39%
◇ Over 40%

ATTACHMENT 4

Rents for Soft Markets in 1988



Senator **Graham**. Thank you very much, Mr. Adams.

Dr. Morton Schussheim, Senior Specialist in Housing, Congressional Research Service.

Dr. Schussheim.

STATEMENT OF MORTON SCHUSSHEIM, SENIOR SPECIALIST IN HOUSING, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS, WASHINGTON, DC

Mr. **Schussheim**. Thank you, Mr. Chairman. I've already submitted a paper to the committee and I won't read it. I simply want to summarize a few of the things that I have in my paper. It tends to confirm or reinforce things that have already been said.

The questions we try to address are these:

Are there indications that developers of moderate rehab projects selected properties in areas where HUD's fair market rents were high relative to going prices and rents of existing rental properties?

And a corollary: If this were the case, did developers reap excess profits from this kind of situation in which property values and rents were softening, or even collapsing?

Our findings are for 20 projects that were coinsured by Benton Mortgage Co. We're indebted to the Inspector General's Office for providing us with some of the facts; we ourselves gathered data based on vacancy rates in those areas, changes in building permits and the rent component of the Consumer Price Index in order to ascertain the strength or weakness of the markets.

And my chart on table A in the statement indicates that for 13 projects in our list of 20, the rental markets at the time these projects were approved were either weak or very weak. We had rental vacancy rates in the Denver area, where several of the projects were located, in the range of 11–14 percent at that time.

In Arlington, TX, the vacancy rate was up to 17–18 percent during that period.

Tulsa, OK had a very high rate.

Casper, WY had apparently a very high rate, somewhere on the order of 20 percent or more.

And by the way, I should say that during that period, rental vacancies in the United States as a whole ranged between 7.3 percent and 7.7 percent, so vacancy rates in a given community like Denver of 11–14 percent would indicate quite a loose rental supply.

When we looked at building permits, which is another indicator of activity in an area, for the United States as a whole, 1987 was a declining year. We came down about 13 percent in building permits from 1986, but some areas really took a dive.

For example, the Arlington, TX area, this is the Forth Worth area, came down 45 percent.

The Denver area was down 47 percent from the previous year.

Oklahoma City had a drop of 40 percent.

So, these indicators generally are consistent with changes in the rental component of the CPI Index. And that's another confirmation of our conclusions about the softness, the relative softness of the areas in which these projects were located.

Now, did the developers actually seek out areas that had very soft markets? I can't prove that from the data that I have. All I can say is that it's a plausible hypothesis that they would because you could get your properties at a low price and relate them to fair market rents that hadn't been adjusted downward against soft markets. And you could come out much better, of course, than in a more expensive market area.

The points that I would like to make in closing are these:

Had we allocated these section 8 Mod Rehab funds to areas on the basis of need it is clear that the areas that were chosen would not have obtained such a large proportion of the projects.

Second, the fair market rents themselves to which many of the project rents approach in the amounts that were allowed to the developers were probably excessive. We've seen evidence of that and it meant clearly that if they were even 10 percent too high for every 100 units that were provided, we could have gotten perhaps another 10 units or more.

So I would say that we have evidence that is consistent with the information that has been presented by our two colleagues.

Thank you.

[The complete prepared statement of Morton Schussheim follows:]

STATEMENT OF MORTON J. SCHUSSHEIM, SENIOR SPECIALIST IN HOUSING, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS, AUGUST 2, 1989

My name is Morton Schussheim. I am senior specialist in housing at the Congressional Research Service of the Library of Congress.

At the request of the Committee, I assembled information on rental market conditions in areas where 20 coinsured mortgage loans were originated by Benton Mortgage Company under FHA's multifamily coinsurance program, Section 244. All of these loans were made on projects receiving Federal rental assistance for low-income people through the Section 8 Moderate Rehabilitation Program.

Fifteen (15) of the projects had their contract rents approved under an agreement to enter into a housing assistance payment (AHAP) in 1987; 1 was approved in December, 1986; and 4 projects had their contract rents approved in 1988. I mention these dates because we were trying to establish rental market conditions at the time the projects were first approved.

Also, it may be relevant to note that certain developers or developer groups were involved with more than one project. One group sponsored 6 of the projects in our list of Benton coinsured Mod Rehab properties; one developer was the principal in at least 3 projects and apparently involved in at least 3 others; 2 other individuals or groups were principals in at least 2 other projects; and in one case there may have been an identity of interest between a developer and an officer of the mortgage company. (This information was provided by the HUD Office of Inspector General.)

CRS was asked to address the following questions:

• Are there indications that developers of Moderate Rehabilitation projects selected properties in areas where HUD's Fair Market Rents (FMR) were high relative to going prices and rents of existing rental properties?

• Were developers able to reap excess profits from a situation in which property values and rents were softening or even collapsing while FMR's remained comparatively high?

Findings

There are pretty good indications that rental markets were weak or softening at the time projects and contract rents were approved in locations of 13 of the 20 projects we examined. Weak rental market areas included:

Denver, Colorado area -- 3 projects
Casper, Wyoming area -- 3 projects
Tulsa, Oklahoma area -- 2 projects
Oklahoma City area -- 2 projects
Arlington, Texas area -- 1 project
Salt Lake City, Utah area -- 1 project
Columbia, S.C. area -- 1 project

One area--Dade County, Florida--was apparently overbuilt in early 1988 when a project was approved there.

Six projects were in areas with strong or moderately strong rental markets:

Las Vegas, Nevada -- 3 projects
Baltimore-Essex, Md. area -- 1 project
Charlotte-Gastonia, N.C. area -- 1 project
Washington, D.C.-Seat Pleasant, Md. area -- 1 project

Fair market rents are set by HUD annually for entire metropolitan market areas and nonmetro areas. Even in strong metropolitan rental market areas, there may be softness in some submarkets. So it's possible that some or all of the 6 projects listed as being in strong rental markets were in soft pockets and could have benefited from relatively high FMR's for the entire area.

How Rental Markets Were Classified

One indicator of weakness or strength in a housing market is the vacancy rate. The rental vacancy rate for the United States as a whole in the period under scrutiny ranged between 7.3% (1986) and 7.7% (1988). Areas classified as weak had rates estimated by the Census Bureau or private market sources of 11% or higher. The estimated vacancy rates are shown in the attached table.

Another indicator is the year-to-year change in building permits issued to builders in a market area. For the country as a whole, building permits declined 13% in 1987 from the 1986 volume. (1987 was the year most of the projects were approved.) But areas like Denver, Oklahoma City, Fort Worth-Arlington, and Salt Lake City had declines in building permits of 40% to 54% during the period.

Changes in the rent component of the Consumer Price Index maintained by the Bureau of Labor Statistics are another indicator of a tight or sluggish rental market. These changes are used by HUD in adjusting FMR's for an area from year to year. Small changes in the CPI rent figures for certain areas during the period, as in Denver, Fort Worth, and Dade County, are generally consistent with the other indicators of weak or weakening rental markets.

Developers' Choice of Market Areas

Did developers pick areas with weak rental markets for Moderate Rehab projects? A priori, it would be reasonable to infer that a knowledgeable developer would seek out situations where properties could be obtained at comparatively low prices with the hope or expectation of having subsidized rents set at or close to the maximums permitted under HUD's Fair Market Rent schedules

In fact, a number of the projects were able to obtain contract rents close to 120% of the FMR's for existing units, the maximum usually allowed by HUD for Moderate Rehab projects. And the contract rents in these projects were certainly high in comparison with average rents of existing housing already under Section 8 contracts in the same areas.

The analysis presented here cannot determine whether developers deliberately sought out soft markets for Moderate Rehab projects. But the data lend plausibility to such a hypothesis.

Did developers of such projects reap excessive profits by selecting projects in areas with Fair Market Rents that were high relative to rents required to cover operating expenses and capital charges including a normal return on equity? Again, one would need more information than rental market conditions to begin to answer that question. A number of factors could have made for generous returns or capital gains to developers, including uncertified rehabilitation cost items and the sale of tax credits on the projects to other parties. But finding a property for Moderate Rehabilitation in a weak rental market or submarket would have been a good way to start the process.

This completes my statement.

Fair Market Rents For Existing Housing in Locations of 20 Moderate Rehabilitation Projects Coinsured by Benton Mortgage Company:

1986-1989

Prepared by Congressional Research Service

Project	Market Area	Date of AHAP	Gross Contract Rent[a]	Fair Market Existing 2BR[a] 1985	1987	1988	1989[b]
Baltimore Gardens	Las Vegas, NV	5/87	699	524	553	595	[illegible]
Cleveland Gardens	Las Vegas, NV	6/87	629	524	553	596	[illegible]
Sierra Pointe	Clark Co., NV	2/87	646	524	553	596	[illegible]
Sierra Vista	Denver, CO	4/87	599	495	495	502	[illegible]
Sun Garden	Tulsa, OK	6/87	530	431	442	462	[illegible]
Windsong	Tulsa, OK	2/87	517	431	442	462	[illegible]
Kingsley Park	Essex, MD	7/87	574	464	479	508	[illegible]
Colony	Columbia, SC	8/87	489	394	403	420	[illegible]
Pebble Creek	Arlington, TX	12/87	509	410	417	421	[illegible]
West Dade	Dade Co., FL	3/88	508	445	445	452	[illegible]
Four Seasons	Gastonia, NC	12/87	431	381	390	407	416
Fox Glenn	Seat Pleasant, MD	12/86	700	530	563	671	[illegible]
Trenton	Salt Lake City, UT	1/87	443	350	367	390	[illegible]
Clayfed	Denver, CO	8/87	594	495	495	502	[illegible]
Rolling Green	Edmond, OK	3/87	516	424	435	455	[illegible]
Windsor Court	Aurora, CO	7/87	589	495	495	502	[illegible]
Terrace Apts.	Oklahoma City, OK	7/87	479	424	435	455	[illegible]
Spring Hill I, II, III	Casper, WY	8/88	554	500	525	563	[illegible]

SOURCES: Project data from HUD Office of Inspector General;
Fair Market Rents from Federal Register.

---

[a] All are two bedroom units except West Dade and Trenton : one bedroom units.

[b] Proposed to take effect October 1, 1989.

Rental Market Indicators

Locations of 20 Coinsured Moderate Rehabilitation Projects

Originated by Benton Mortgage Company

Table A

Project	Market Area	Developer	Building Permits Percent Change 1986 to 1987[*]	Rental Vacancy Rate 1986 - 1987[**]	Rental Housing Market
Baltimore Gardens	Las Vegas, NV	A	+ 6%	7-8%	Moderately Strong
Cleveland Gardens	Las Vegas, NV	A	+ 5%	7-8%	Active Construct.
Sierra Pointe	Las Vegas, NV	B	+ 5%	7-8%	Moderately Strong
Sierra Vista	Denver,CO	B	- 47%	11-14%	Very Weak
Sungarden	Tulsa, OK	C	-17%	12%	Weak
Windsong	Tulsa, OK	B	-17%	12%	Weak
Kingsley Park	Essex, MD	D	- 6%	7-8%	Moderately Strong
Colony Apts.	Columbia, SC	E[3]	-27%	NA	Weak
Pebble Creek	Arlington, TX	F	-45%	17-18%	Very Weak
West Dade	Dade Co, FL	G	- 9%	8-9%	Weakening
Four Seasons	Gastonia, NC	H	+ 9%	6-9%	Fairly Strong
Fox Glenn	Seat Pleasant,MD	I/D	+ 4%	4-5%	Strong
Tranton	Salt Lake City	J[4]	-54%	14-16%	Very Weak
Clayfed	Denver, CO	K	-47%	11-14%	Very Weak
Rolling Green	Edmond, OK	B	-40%	13% (1984)	Weak
Windsor Court	Aurora, CO	B	-47%	11-14%	Very Weak
Terrace Apts	Oklahoma City	B	-40%	13% (1984)	Weak
Spring Hill I, II, III	Casper Wyoming	L[5]	(10 units)	21-30%	Very Weak

Prepared by Congressional Research Service

Sources: Project data from HUD Office of Inspector General
Fair market rents from Federal Register
Building permits from Bureau of Census
Rental vacancy rates from U.S. Housing Markets, Lomas Mortgage and American Housing Survey

---

[*] U.S. Percent change 1986 to 1987: -13%; permits for entire market area.

[**] U.S. Rental vacancy rates: 1986–7.3%; 1987 and 1988–7.7%;

[3] Possible identity of interest with officer of Benton Mortgage Company.

[4] One principal also in Developer group B.

[5] Principal also in several Group B projects.

Rental Market Indicators

Locations of 20 Coinsured Moderate Rehabilitation Projects

Originated by Bentem Mortgage Company

Table B

Project	Gross Contract Rent(C)[1]	Fair Market Rent Existing (2)	Average Gross Rent Sec. 8 (3)	Contract Rent as Percent FMR (1:2)	Contract Rent as Percent Average Sec. 8 (1:3)
Baltimore Gardens	692	586	448	117%	156%
Cleveland Gardens	629	596	448	106%	140%
Sierra Pointe	645	596	448	108%	144%
Sierra Vista	599	502	489	119%	122%
Sungarden	530	462	351	115%	151%
Windsong	517	462	351	112%	147%
Kingsley Park	574	506	415	113%	138%
Colony Apts.	489	420	367	116%	133%
Pebble Creek	509	421	402	121%	127%
West Dade	508	452	377	112%	135%
Four Seasons	431	407	303	106%	142%
Fox Glenn	700	671	612	104%	114%
Trenton	443	390	356	114%	124%
Clayford	594	502	489	118%	121%
Rolling Green	516	455	350	113%	147%
Windsor Court	589	502	489	117%	120%
Terrace Apts.	479	455	350	105%	137%
Spring Hill I, II, III	564	563	413	100%	137%

---

[1] Rents for 2 bedroom units except for West Dade and Trenton which are one bedroom units. All figures include utilities.

Senator **Graham**. Thank you very much, Doctor.

I'd like to pursue further the question of how the fair market rents were calculated?

Mr. Ols, could you pick one of your eight projects and walk us through the procedure by which the rental rates were established?

FAIR MARKET RENTS

Mr. **Ols**. That was not part of our analysis. Maybe Paul Adams could respond.

Mr. **Adams**. I'll ask Mr. Greer, who is with me today, to answer that question, if I might.

Mr. **Greer**. Excuse me, sir, are you talking about the fair market rents?

Senator **Graham**. Yes.

Mr. **Greer**. Fair market rents for the section 8 Existing Program are computed by HUD's Office of Policy Development and Research on an annual basis, starting with census data, which at the present time, they're using 1980, is updated annually through the American Housing Survey. And for each designated area of the country, a formula is used to establish what the rent should be, based on the recent movers in that marketplace, for a two-bedroom unit.

That's basically how fair market rents are established.

Now, the fair market rent for a Mod Rehab project——

Senator **Graham**. Excuse me. When you say "recent movement," is that an actual assessment of what rents are being paid in the open marketplace in that area?

Mr. **Greer**. Yes. For the Mod Rehab FMR's, those are 20 percent higher than the existing section 8 rents, and the 20 percent gap is to pay for the debt service on the financing to cover the rehab costs of Mod Rehab.

Senator **Graham**. Is that 20 percent across the board, or is it related to the actual expenditures on the project?

Mr. **Greer**. It's supposed to be related to the actual expenditures on the project. But, for the fair market rent computation, it's simply a 20-percent add-on.

Mr. **Schussheim**. Sir, as I understand, the 20 percent is a ceiling for the Mod Rehab units over and above the amounts that are permitted under the schedule for existing. No project has to go up to a maximum. It depends upon the costs that are presented by the developer.

And, presumably, after review by our good public housing agencies to be sure.

Senator **Graham**. So you say the 20 percent represents a ceiling. Is that your understanding, Mr. Greer?

Mr. **Greer**. The 20 percent, the fair market rent, in fact, is a ceiling rent, the maximum that can be assessed. That's a good point.

Mr. **Schussheim**. Also, I would add that the fair market rent is supposed to be set at the 45th percentile for standard units that are not luxury in that community.

That would be the rents paid by people who had moved within the past 2 years. To the extent that HUD has that data; we have to recognize that the information HUD has in setting the fair market rents is not too great. It's tenuous.

As you move away from the 1980 census, the figures become more and more squishy. They do try to adjust those figures using the CPI Bureau of Labor Statistics Rent Index. But, even there, we don't have those figures for every single metropolitan area. We may have them for a region, and the regional increases may be much higher than for the specific community where that rent schedule is determined.

So, HUD lacks adequate data, in my opinion, to set fair market rents in a fairly definitive way.

Senator **Graham**. Mr. Terner, if you were to go into a new area, say, you hadn't built previously in San Jose, and the question was: What kind of rents can I anticipate on this project? How would you go about making the determination?

Mr. **Terner**. We do a market study which would really be looking at comparable units, the same kind of product we expect to produce, and seeing what consumers were paying for those units.

Senator **Graham**. Using a scale of zero to 10 with 10 being the sophistication necessary to go to Mars, where would you rate the sophistication required to do a market survey of comparable rents?

Mr. **Terner**. About .1.

Senator **Graham**. To come back to any of the three members of panel two:

Is the fact that HUD uses a system that appears to be so inept in arriving at the desired conclusion, a mandate of law, a requirement of HUD regulation or standard operating procedure?

Mr. **Greer**. I think the statute simply says that HUD needs to establish the process; it doesn't get into the nitty-gritty of how that process should be handled.

Mr. **Ols**. Mr. Chairman, I might add that we issued a report in February of this year that talked about the vouchers and certificate programs which basically are determined by the fair market rent values.

One of the major chapters we had in that report was inaccurate fair market rents affect program costs and tenant reimbursements. It doesn't relate to the Mod Rehab Program, per se, but it's a discussion of that problem. We pointed the same thing out: Inadequate data. Old data. And it's not up to date, as we've heard.

Senator **Graham**. Mr. Ols, I'd like to request that that study be submitted and incorporated as part of the record of this hearing.

Mr. **Ols**. I'd be happy to.

[Information furnished:]

United States General Accounting Office

GAO

Report to the Chairwoman, Subcommittee
on HUD-Independent Agencies,
Committee on Appropriations, U.S. Senate

February 1989

RENTAL HOUSING

Housing Vouchers Cost More Than Certificates but Offer Added Benefits

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-224834

February 16, 1989

The Honorable Barbara Mikulski
Chairwoman, Subcommittee on HUD
-Independent Agencies
Committee on Appropriations
United States Senate

Dear Madam Chairwoman:

In response to the April 20, 1987, request of your predecessor, Senator William Proxmire, this report provides information on the costs of the Department of Housing and Urban Development's (HUD) section 8 existing certificate and housing voucher programs. It also contains information on the adequacy of HUD's fair market rents and their impact on tenant rent burdens.

As agreed with the Subcommittee office, we are sending copies of this report to the appropriate congressional committees; the Secretary of Housing and Urban Development; and the Director, Office of Management and Budget. Copies will also be sent to other parties upon request.

This work was done under the direction of John M. Ols, Jr., Director, Housing and Community Development Issues. Major contributors are listed in appendix IV.

Sincerely yours,

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

About a million low-income households are currently receiving rental assistance through the Department of Housing and Urban Development's (HUD) section 8 existing certificate or housing voucher programs. The administration has proposed that the certificate program be replaced with the voucher program, claiming that vouchers are less costly and more efficient. However, debate surrounding the comparative merits of both programs prompted the Chairman, Subcommittee on HUD-Independent Agencies, Senate Committee on Appropriations, to request that GAO compare the costs of vouchers and certificates and determine the costs of converting outstanding certificates to vouchers. The Chairman also asked GAO to assess the adequacy of HUD's fair market rents (FMRs) and their impact on tenant rent burdens.

Background

Housing vouchers, which were established in 1983, and certificates, which were established in 1974, are two very similar programs whose identical goals are to provide subsidies for low-income families to live in private rental housing that is decent, safe, and affordable. A distinct feature of the voucher program is the incentive it provides families to "shop around" for housing best suited to their needs. This feature distinguishes vouchers from certificates in terms of the way public housing agencies (PHAS) compute tenant rent subsidies.

In the certificate program, subsidies are based on the difference between 30 percent of an assisted family's adjusted monthly income and its actual rent payments, which cannot exceed the FMR for the area. In the voucher program, subsidies are based on the difference between 30 percent of an assisted family's adjusted monthly income and the FMR for the area. Families may choose to rent units priced above the FMR and pay the additional rent themselves. However, if a family's actual rent is less than the FMR, PHAS' rent subsidies are based on the higher FMR, thereby reducing a family's actual out-of-pocket expenses.

Results in Brief

The voucher program's shopping incentive provides low-income families more flexibility in choosing housing and higher average subsidies than certificates. These higher subsidies, however, result in vouchers that cost more than certificates and, therefore, serve fewer families. HUD's contention that vouchers are less costly than certificates is misleading because HUD uses different budgeting approaches to compute program costs.

Beginning in 1989, subsidies for 780,000 outstanding certificates will begin expiring. HUD plans to refinance these certificates with vouchers. Because certificate families who have been in the program for a number of years are often paying less than FMRS, it would be costly to begin subsidizing these families based on higher FMRS instead of their lower actual rents.

FMRS influence the degree of success low-income families have in locating affordable rental units and, in the voucher program, the percentage of income they pay for rent. Even though HUD uses the best available central data sources in making rent determinations, there are limitations in the data that can cause FMRS to be either too high or too low in certain areas.

Principal Findings

Vouchers Cost More Than Certificates but Provide Added Benefits

The latest data available indicate that voucher costs are likely to be higher than certificate costs. Using data from HUD's first-year report on the housing voucher program, GAO calculated that with HUD's 1989 budget request, about 9,500 (or 6 percent) fewer families can be assisted with vouchers than with certificates. To assist the same number of families with vouchers would cost an additional $208 million.

Vouchers are more costly because, compared with certificates, they provide higher subsidies to those families who rent units for less than FMRS. Voucher families, however, must pay the difference between FMRS and higher actual rents and, in some cases, assisted voucher families are paying over 60 percent of their incomes for rent.

Budgeting Processes Are Inconsistent

HUD has told the Congress that the voucher program is less costly than the certificate program. This statement, however, is misleading because HUD uses different methods to estimate the costs for each program. In presenting the costs of these programs in its budget, HUD does not clarify that these different approaches were used, which makes it difficult for the authorizing Committees to fully evaluate the merits of each program and establish appropriate funding levels.

Converting Certificates to Vouchers Would Be Costly

Over the next 12 years, 780,000 section 8 certificates will expire. HUD plans to refinance these certificates with vouchers. Data GAO obtained on 87,000 certificate tenants show that their rents averaged 15 percent below FMRs. Because voucher recipients who rent below FMRs receive larger subsidies, the first-year costs to refinance the 87,000 certificates would be $83 million greater than if they were refinanced with certificates. Although this sample is not statistically projectable, GAO calculated that if these rent differences are representative of the 780,000 expiring certificates, the cumulative additional cost to refinance them with vouchers over the next 12 years would be $9.6 billion. This differential, expressed in terms of its discounted present value, equals $4.3 billion.

Fair Market Rents Are Not Always Accurate

HUD's FMRs do not always accurately reflect actual market rents. Even though HUD uses the best available national data in setting its FMRs, these data are not always current nor geographically specific. Consequently, FMRs are sometimes set too high, which can result in PHAs oversubsidizing tenants. Conversely, FMRs are sometimes set too low, which can result in tenants having high rent burdens and/or difficulty in locating affordable rental units.

GAO's review of housing assistance in the Houston, Texas, area, which has surplus rental housing, shows that FMRs appear to be too high. This results in PHAs oversubsidizing some families at the expense of other low-income families who go unserved. On the other hand, FMRs appear to be too low for the more expensive counties included in the New York City housing market. This results in certificate families experiencing considerable difficulty in finding housing and in voucher families having unusually high rent burdens.

Matters for Congressional Consideration

GAO believes that operating one rental assistance program is advantageous. It would provide consistent benefits to program recipients and a unified approach to delivering housing assistance. If the Congress elects to have one program, it will need to evaluate the merits and drawbacks of features presently distinguishing vouchers from certificates and adopt those features that best satisfy the programs' legislative intent of providing decent, safe, and affordable housing. A key feature is whether subsidies should be based on actual rents as in the certificate program or FMR payment standards as in the voucher program. And,

- if subsidies are based on FMR payment standards, should shopping incentives be paid to tenants who rent in place—especially tenants with expiring certificates, or,
- if subsidies are based on actual rents, should families be allowed to rent units with rents above the FMR payment standards.

Another key feature is whether program budgeting should be based on a fixed number of families to be served as in the certificate program or fixed dollar allocations as in the voucher program.

Recommendations

The Secretary, Department of Housing and Urban Development, should (1) identify areas where FMRs may be either too high or too low and make necessary adjustments and (2) establish consistency in the budgeting processes for certificates and vouchers.

Agency Comments

HUD agreed that the voucher and certificate programs should be combined into a single subsidy program. But, HUD raised concerns regarding GAO's cost comparison of vouchers and certificates, which it said could lead to erroneous conclusions.

HUD contended that the report relies solely on the results of the first year of the voucher demonstration and that the second-year results will show that vouchers are less costly than certificates. GAO believes that its conclusions are appropriate. The report refers to several data sources other than the voucher demonstration used in GAO's analyses. The report also discusses the principal features distinguishing the two programs, such as the "shopping incentive," and how these features affect low-income tenants and program costs regardless of the outcome of the second year of the voucher demonstration.

GAO emphasizes that it does not take a position favoring either vouchers or certificates but believes that the Congress should examine the merits and drawbacks of features presently distinguishing the programs and adopt those that best satisfy the programs' legislative intent. HUD did not comment on the report's recommendations concerning establishing consistency in the budget process for vouchers and certificates and improving the process of setting FMRs. (See ch. 4 and app. III.)

Contents

Executive Summary 2

Chapter 1 Introduction 8
- The Existing Certificate Program 8
- The Housing Voucher Program 9
- Objectives, Scope, and Methodology 11

Chapter 2 Housing Vouchers Are More Costly Than Certificates but Provide Greater Benefits to Some Households 14
- Voucher's Shopping Incentive Increases Costs and Has Questionable Impact on Housing Choices 15
- FMRs May Be Too High for In-Place Renters 23
- Disparities in Current Budgeting Practices Prohibit Meaningful Cost Comparisons 26
- Converting Existing Certificates to Vouchers Is a Potentially Costly Proposition 30

Chapter 3 Inaccurate Fair Market Rents Affect Program Costs and Tenant Rent Burdens 32
- FMRs Are Not Always Accurate 32
- Rental Housing Is Widely Available Below the FMR Ceiling in the Houston Area 33
- Rental Units at or Below the FMR Ceiling Are Extremely Difficult to Locate in the New York City Area 37

Chapter 4 Conclusions, Matters for Congressional Consideration, and Recommendations 42
- Conclusions 42
- Matters for Congressional Consideration 45
- Recommendation to the Secretary of HUD 46
- Agency Comments 46

Appendixes
- Appendix I: Methodology Used to Estimate the Federal Costs of Section 8 Certificates and Housing Vouchers 50
- Appendix II: PHAs Providing GAO With Information Used to Estimate the Cost of Converting Existing Certificates to Vouchers 54
- Appendix III: Comments From the Department of Housing and Urban Development 56
- Appendix IV: Major Contributors to This Report 58

Table

Table 3.1: Success Rates in Locating Rental Units in the New York City Area During Fiscal Years 1986 and 1987 40

Figures

Figure 2.1: Monthly Housing Assistance Payments and Tenant Contributions at Various Rent Levels, Vouchers and Certificates 16
Figure 2.2: Vouchers Cost 7 Percent More Than Certificates Over a 5-Year Benefit Period 19
Figure 2.3: Certificates Could Serve 9,500 More Families Than Vouchers, Based on HUD's Fiscal Year 1989 Voucher Budget Request 20
Figure 2.4: Voucher Tenant Rent Burdens, Movers and In-Place Rentals 25
Figure 2.5: Refinancing 87,000 Existing Certificates With Vouchers Would Increase First-Year Federal Subsidy Payments by $83 Million 31
Figure 3.1: Comparison of FMRs With CPI and Private Rent Study in Houston Area 34
Figure 3.2: Oaks of Woodforest, Harris County PHA 36
Figure 3.3: Parkside Place, Pasadena PHA 36
Figure 3.4: Kendlewood Apartments, Liberty County PHA 37
Figure 3.5: 75 Broadway, Yonkers; Westchester County PHA 41

Abbreviations

CPI	consumer price index
CRS	Congressional Research Service
EHAP	Experimental Housing Allowance Program
FMR	fair market rent
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
OMB	Office of Management and Budget
PHA	public housing agency
PMSA	primary metropolitan statistical area

Chapter 1

Introduction

In 1974, the Congress passed legislation creating a new rental assistance program for low-income families. The program, commonly referred to as the section 8 certificate program, subsidizes household rent payments in existing privately owned housing by paying a portion of recipients' actual rents. A similar program, known as the housing voucher demonstration program, was authorized by the Congress in 1983. This program, like the certificate program, also subsidizes the rents of low-income families in privately owned rental housing. However, unlike the certificate program in which federal subsidies are based on the actual rent paid to a private landlord, federal subsidies under the voucher program are based on a Department of Housing and Urban Development (HUD) computed fair market rent (FMR) for specific areas.

For the past several years, both programs have operated concurrently. However, the administration has proposed that vouchers be used in the future as the primary federal housing subsidy program. Uncertainty, particularly over the budgetary ramifications of this proposal, prompted the Chairman, Subcommittee on HUD-Independent Agencies, Senate Committee on Appropriations, to ask us to compare the current costs of issuing certificates versus vouchers, as well as comparative costs of converting outstanding certificates to vouchers. The Chairman also asked us to evaluate the adequacy of HUD's fair market rent determinations under different market conditions.

The Existing Certificate Program

Prior to 1974, HUD's principal housing assistance programs provided subsidies for the construction or rehabilitation of additional low-income housing. This housing was then rented to lower income families at below market rates. Beginning in the early 1970s, interest developed in making greater use of existing privately owned housing. Accordingly, a 10-year Experimental Housing Allowance Program was initially authorized in 1970 to test the feasibility of subsidizing tenants rather than the builders of low-income rental housing.

Early experience under the experimental program led the Congress in 1974 to add section 8 to the United States Housing Act of 1937 (42 U.S.C. 1437f), creating the Existing Rental Assistance Certificate Program to provide rental assistance to low-income families. According to the act, the certificate program was to help lower income families obtain a decent place to live and promote economically mixed housing.

How the Program Works

The certificate program is administered by some 2,000 state and local public housing agencies (PHAS) nationwide. PHAS certify families' eligibility for assistance, issue housing assistance certificates to eligible families, assist certificate holders in finding adequate housing units in the private market, and inspect housing units to ensure that they meet HUD's housing quality standards. Families participating in the section 8 existing certificate program are principally very low-income households earning 50 percent or less of the median income for the area in which they live. These families are selected from waiting lists maintained at their local PHA.

The program provides subsidies to tenants by paying a monthly stipend to a private landlord on their behalf. An assisted family pays 30 percent of its monthly adjusted income for rent, and the PHA pays the landlord the difference between the tenant's payment and an approved monthly rent. The unit the tenant selects must meet HUD's housing quality standards, and the monthly rent must be equal to or less than a HUD-determined FMR for the area. HUD sets FMRS to represent the typical price for a modest rental unit for families of various sizes. In fiscal year 1987, the federal government provided, through the certificate program, rental assistance to about 800,000 low-income families.

The Congress approves new certificates each year and authorizes funds to HUD for a 15-year budget period. The 15-year budget authority assists PHAS in maintaining long-term stability in operating their certificate program.

The Housing Voucher Program

Housing vouchers were recommended by the President's Commission on Housing, which was created in June 1981 to find remedies to the housing problems that affect millions of Americans. The Commission reported that the primary housing problem in the country was one of affordability rather than availability of housing. Accordingly, the Commission recommended that federal subsidies be used to help low-income families afford privately owned housing rather than for the construction of additional low-income housing.

In considering the Commission's recommendations, the administration found that only the certificate program was specifically designed to address the affordability problem. After analyzing the program's underlying policies and the way in which it was being delivered, the administration concluded that, while the program was generally doing a good job, several aspects could be improved. The administration's changes were incorporated into a newly designed housing voucher program, which the Congress authorized in the Housing and Urban-Rural Recovery Act of 1983 (Titles I-V of P.L. 98-181) as a 5-year demonstration program. The program was reauthorized by the Housing and Community Development Act of 1987 (P.L. 100-242).

How the Program Works

The voucher program, like certificates, is administered by PHAs throughout the country. These PHAs certify family eligibility for voucher assistance and ensure that HUD's housing quality standards are met. Like the certificate program, vouchers primarily assist families with incomes of no more than 50 percent of the area's median income.

A principal change brought about by vouchers is the added flexibility it provides to low-income families by allowing them to rent units above established FMRs. Also, if families rent units below FMRs, they can keep the difference between actual rents and the applicable FMR. The opportunity to keep this difference provides families with an incentive to rent below FMRs. This feature is commonly referred to as a "shopping incentive." The Congress expected that the application of this shopping incentive would constrain private landlord rent increases since families would have a monetary incentive to obtain the most favorable rent. Since certificates do not provide a shopping incentive, the Congress perceived that landlords are motivated to raise rents to FMR ceilings.

The Senate report on the housing voucher legislation (report no. 98-142, May 23, 1983) discussed the importance of the program's shopping incentive feature:

> "This housing payment certificate program will improve the Section 8 existing housing program by giving very low-income families more flexibility to 'shop around' for housing best suited to their needs. . . . This shopping incentive will give assisted tenants the same choice between housing and other needs that they would exercise in using their own money. This choice by tenants will constrain the inflationary impact on rents in the current Section 8 program where landlords often just raise rents up to the maximum fair market since tenants get no savings from a lower rent. The shopping incentive feature is the essential element of the Administration's 'housing voucher' proposal and has been accepted by the Committee as a way to bring some discipline of market transactions to tenants in the existing housing program."

Aside from the shopping incentive, other differences between the programs include the method of program budgeting, a rent reasonableness test, treatment of welfare rent payments in several states, and tenant rent burdens. These differences are discussed further in chapter 2.

The Housing and Community Development Act of 1987 eliminated several other features that had previously also distinguished vouchers from certificates. Specifically, the act (1) equalized PHA administrative fees for both vouchers and certificates (previously, fees for vouchers were less), (2) provided that certificate holders could also choose housing outside the jurisdiction of their specific PHA within the same or a contiguous metropolitan statistical area (this portability provision before the act applied only to vouchers), and (3) authorized annual rent adjustments for voucher recipients (prior authority provided for only two adjustments over a voucher's 5-year authorization).

HUD contracted in February 1985 with Abt Associates, a private consulting firm, to evaluate the housing voucher demonstration program. The ongoing evaluation is being conducted at 20 of the nation's largest PHAS and calls for an examination of the general effectiveness of rental subsidies provided by the certificate and voucher programs and a comparison of the use of certificates and vouchers. An interim report on the results of the evaluation was released in June 1987. According to HUD officials, a final report is scheduled for the spring of 1989.

Objectives, Scope, and Methodology

The former Chairman, Subcommittee on HUD-Independent Agencies, Senate Committee on Appropriations, asked us to

- compare the cost of housing vouchers with section 8 certificates,
- examine the cost of converting existing certificates to vouchers, and
- determine the adequacy of HUD's FMR determinations and their impacts on tenant rent burdens in distinct housing markets.

To accomplish these objectives, we analyzed program regulations and data obtained from several sources, including HUD's central office, its New York and Fort Worth regional offices, and its Houston field office; four PHAS in the New York City area (New York City, Westchester County, Rockland County, and Putnam County); four PHAS in the Houston area (city of Houston, Harris County, Liberty County, and city of Pasadena); several realtors in New York; and apartment survey firms in the Houston area.

We developed financial models to compare the cost of housing vouchers with section 8 existing certificates. As a baseline for our cost assumptions, we used summary data on certificates and voucher tenant rents, subsidy costs, and tenant payments from the first year of HUD's housing voucher demonstration. We estimated subsidy cost changes over time and the number of households that could be assisted, which HUD used in preparing its fiscal year 1989 budget request. In our analysis, we used a similar benefit period for both the certificate and voucher programs to provide a basis for comparing program costs over time. Appendix II discusses the methodology we used to estimate and compare the federal costs of providing section 8 certificates versus housing vouchers. To calculate the costs of converting existing certificates to vouchers, we obtained data on certificate tenants from the PHAS we visited in the New York City and Houston areas and through telephone surveys with officials at 13 other large PHAS nationwide. Appendix III contains a listing of the PHAS we contacted. The PHAS provided us with information on the average gross rents, average tenant payments, average subsidy payments to landlords, and fair market rents, broken out by bedroom size, for all certificate tenants on their rolls as of December 31, 1987. Data from New York City were obtained as of December 1, 1987. Rent payment information obtained from the PHAS covered approximately 87,000 certificate tenants.

To examine tenant rent burdens and fair market rents, we selected two areas of the country with significantly different housing markets. The New York City area was selected because it is the largest user of housing vouchers, and it has a tight rental market, experiencing a rental vacancy rate of about 2 percent. The Houston area was selected because it is also a large user of housing vouchers, and it represents a loose rental market, experiencing a rental vacancy rate of up to 18 percent.

To determine the availability and quality of section 8 rental housing available in the Houston and New York areas, we performed a limited market survey by using the information and data sources that PHAS furnish to section 8 applicants. In the Houston area, we contacted 40 apartment complexes that were included on listings of rental units provided by PHAS to section 8 applicants and visited 13 apartment projects. In the New York area, rental listings were not available from PHAS, so for a 2-day period at each PHA we examined daily newspapers, rental listing publications, and bulletin boards. We also contacted local realtors and existing section 8 landlords. We visited the one apartment that we were able to locate in the New York area whose landlords rented the units within the FMR and would accept section 8 families.

We performed our work at the PHAS and the HUD field offices between October 1987 and May 1988. Our review was performed in accordance with generally accepted government auditing standards.

Housing Vouchers Are More Costly Than Certificates but Provide Greater Benefits to Some Households

Housing vouchers, on average, cost about 7 percent more than certificates to assist low-income households. Based on HUD's fiscal year 1989 budget request, this 7-percent added cost means that over 9,500 fewer low-income households can be assisted with vouchers. To assist the same number of families would cost an additional $208 million.

The added cost results from the shopping incentive feature of the voucher program. This feature provides a larger rent subsidy than certificates for families choosing to rent units below an area's FMR standard. However, it is unclear from HUD's housing voucher demonstration whether the shopping incentive is achieving one of its primary objectives of encouraging families to shop for housing. Earlier HUD studies have shown that similar incentives have not greatly influenced families' housing choices. What HUD's housing voucher demonstration clearly shows, however, is that low-income families who continue to rent their same pre-subsidy units without moving (renting in-place) receive greater benefits than they would under the certificate program.

As long as the shopping incentive remains a distinct feature of the voucher program, voucher per-unit and program costs will always be greater than the certificate program and households renting below the FMR will always receive greater benefits than they would using certificates, assuming no other notable differences exist between the programs. However, other differences add to the debate as to which subsidy mechanism is the most cost-effective. The most notable difference, aside from the shopping incentive, is the programs' budgeting processes. The voucher program is structured to provide a fixed amount of dollars over a 5-year period whereas the certificate program allows for supplemental appropriations should initial budget projections prove inadequate. On the one hand, vouchers bring greater fiscal responsibility at the expense of possibly assisting fewer families, whereas, certificates generally assure that a desired number of low-income households are assisted each year at the expense of possible future budgetary problems. The pros and cons to each of these budgeting approaches are discussed later.

Aside from the programmatic budget differences, HUD has further confused the budgeting process for vouchers and certificates by using different methods to estimate per-unit costs under each program. These methods have resulted in misleading comparisons of the programs' costs in past HUD budgets.

In addition to the current costs of assisting low-income households with either vouchers or certificates, a potentially very costly decision is imminent regarding the proposed conversion of approximately 780,000 outstanding certificates to vouchers. We found, based on data we obtained for 87,000 of these certificates, that the subsidy costs would be about $83 million greater if these families received vouchers, based on FMR payment standards, instead of certificates based on actual rents. The added subsidy costs would reduce family rent burdens below 30 percent. Although our data are not statistically projectable, we calculate that if it were representative of all 780,000 outstanding certificates, there would be a cumulative additional cost of $9.6 billion to convert these certificates to vouchers as the certificates expire over the next 12 years. In terms of its discounted present value, this differential equals $4.3 billion.

Voucher's Shopping Incentive Increases Costs and Has Questionable Impact on Housing Choices

Vouchers pay higher subsidies than certificates when tenants rent units costing less than the FMR. This feature, called a shopping incentive, is intended to encourage recipients to shop for housing best suited to their needs and to make choices between housing and other expenditures. The Congress also intended that this shopping incentive would constrain rent inflation. Past HUD experience with shopping incentives, however, disclosed that these incentives did not work as intended. To date, HUD's voucher demonstration has not evaluated what impact the shopping incentive has had on tenant housing decisions.

Vouchers Are Structured to Pay Higher Subsidies Than Certificates

When families rent below FMRS, voucher subsidies are higher than certificate subsidies. Under vouchers, PHAS pay subsidies initially based on the FMR payment standard regardless of actual unit rents. A tenant contribution, generally 30 percent of adjusted family income, is deducted from this standard. If a family's actual rent is less than the payment standard, the family's actual out-of-pocket expenses are reduced and in effect the family can use the higher subsidy to purchase other goods and services. If the rent is greater than the payment standard, the family must pay the full difference.

Figure 2.1 illustrates a family's rent contribution and the amount of PHA subsidy under three rent scenarios—monthly rents of $400, $450, $500—in the certificate and voucher programs. In all three scenarios, the FMR is assumed to be $450, there are no HUD-granted exceptions to the FMR, and the adjusted family income is assumed to be $500 per month.

Figure 2.1: Monthly Housing Assistance Payments and Tenant Contributions at Various Rent Levels, Vouchers and Certificates

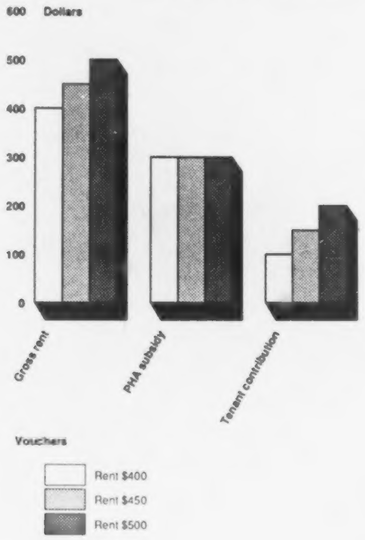
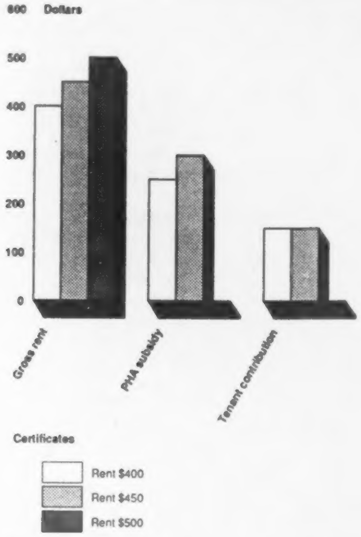


Figure 2.1 continued



The above examples assume a fair market rent of $450 per month and an adjusted family income of $500 per month.

At the $500 gross rent level, a rental unit would be ineligible to participate in the certificate program

Source: GAO examples.

As shown in figure 2.1, certificates hold tenant rent payments constant at 30 percent of adjusted income and PHA subsidy payments vary according to the gross rent level. In contrast, vouchers hold constant the amount of PHA subsidy and tenant rent burden varies according to the gross rent level. With vouchers, households receive a larger subsidy for units renting at $400 than certificate holders do, and their rent burden decreases to 20 percent. Voucher recipients can also rent units costing $500, which is not possible using certificates, but their rent burden increases to 40 percent.

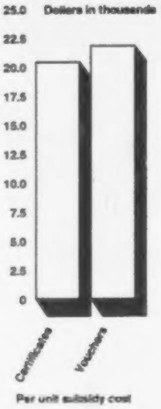
HUD Data Show Vouchers Are More Costly Than Certificates

In June 1987, HUD published the Report of the First Year Findings for the Freestanding Housing Voucher Demonstration which summarizes its early experience under the housing voucher demonstration and compares costs of both the certificate and voucher programs in 18 large urban PHAS. The report shows that in the first year of the voucher program tenant rents were, on average, $32 per month, or 8 percent, higher than certificate tenant rents, reflecting the fact that voucher recipients are allowed to rent above FMR limits. Similarly, PHA subsidy costs were $23 per month, or 8 percent, higher in the voucher program due to voucher recipients renting units below FMRS and receiving higher assistance payments than similar certificate recipients.

Using actual housing subsidy cost data from the first year voucher demonstration report, we calculated that vouchers are 7 percent more expensive than certificates over a 5-year benefit period. This period was used for the analysis because it is the time frame for voucher budget authority and is the minimum benefit period for certificate recipients (certificate contracts generally have an initial 5-year term but are renewable for up to 15 years). We included a 3.4-percent annual rent inflation factor in our analysis, consistent with figures provided to us by HUD's housing budget office.

Figure 2.2 shows our estimates of total subsidy costs for vouchers and certificates over a 5-year benefit period. The data show that, over this period, vouchers cost $21,820 per unit while certificates cost $20,422 (a 7-percent differential).

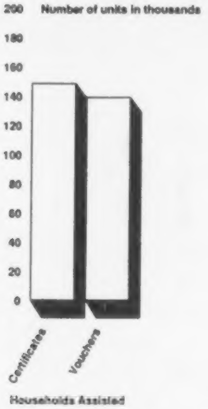
Figure 2.2: Vouchers Cost 7 Percent More Than Certificates Over a 5-Year Benefit Period



Source: GAO calculations using HUD data and budgeting assumptions.

The additional voucher subsidy costs mean that PHAs will be able to issue fewer vouchers than certificates for the same budget allocation. To illustrate, we estimated the number of vouchers and certificates that could be issued based on HUD's fiscal year 1989 request of $3.0 billion in budget authority. Figure 2.3 shows the results of dividing the $3 billion budgetary allocation by our 5-year cost estimates of vouchers and certificates (the budget authority required per household). We calculated that 148,479 certificates or 138,962 vouchers can be issued with the fiscal year 1989 budget authority request, or 9,517 fewer households with vouchers.

Figure 2.3: Certificates Could Serve 9,500 More Families Than Vouchers, Based on HUD's Fiscal Year 1989 Voucher Budget Request



Source: GAO calculations using HUD data from the first-year housing voucher demonstration report and HUD budgeting assumptions

Using the same 5-year cost estimates, we calculated the additional budget authority needed to issue the same number of vouchers as certificates. PHAS would require an additional $207.7 million in budget authority to issue the same number of vouchers as certificates.

HUD officials cautioned that data in the first-year demonstration report may not be representative because the voucher program was new to PHAS, landlords, and tenants. The officials said that the final demonstration report due to be released in the spring of 1989 will provide a broader data base and be more representative. The final report will contain data on the program's second year of operation. While this additional information is not yet available, data we obtained from PHAS we visited in the New York City and Houston areas showed that during fiscal year 1987, voucher recipients continued to pay higher rents—5 percent in Houston and 10 percent in New York City—and PHAS also continued to pay higher subsidies—2 percent in Houston and 21 percent in New York City.

HUD officials said that the housing voucher demonstration report data may overstate cost differences between certificates and vouchers because subsidy payments for certificate families in New York and Michigan were influenced by welfare rent payment rules. In these states, the tenant rent contribution in the certificate program is the larger of 30 percent of adjusted income, 10 percent of gross income, or the portion of the welfare payment designated as rent. The voucher program does not include a welfare rent provision.

To determine the impact of the welfare rent provision, we adjusted our 5-year cost analysis to exclude welfare rent payments from HUD's reported data on the certificate program. This adjustment resulted in the per-unit costs of the certificate program increasing from $20,422 to $20,650, while voucher costs remained at $21,820. Accordingly, the relative cost differential of vouchers over certificates dropped from 7 percent to 6 percent. The number of estimated families served under certificates fell from 148,479 to 146,835 and the differential of fewer vouchers than certificates issued was reduced from 9,517 to 7,873 (6 percent less to 5 percent less). The additional costs to issue the same number of vouchers as certificates decreased from $207.7 million to $171.8 million. HUD has prepared a legislative proposal to apply the welfare rent provision to the voucher program.

Instances in Which Voucher Recipients Were Charged Higher Rents

Contrary to voucher program expectations that tenant shopping would constrain rent inflation, PHA officials in the Houston area cited several instances in which landlords were charging voucher tenants higher rents than certificate tenants occupying similar units within the same project. It is important to clarify, however, that we have no indication to what extent this may be occurring at other PHAS.

Houston PHA officials told us that this practice occurs because there are no procedures to limit the rents a landlord may charge voucher tenants. Rents for certificate tenants, in contrast, cannot exceed the rents a landlord usually charges on the open market, or the FMR rent ceilings, whichever is lower. PHAS assure proper landlord rent charges by conducting a rent reasonableness test for each apartment location. The Houston PHA provided us with examples of three apartment complexes that charged voucher tenants higher rents than certificate tenants occupying similar units. The apartment landlords charged voucher tenants the FMRS, while they charged certificate tenants the going market rent which was between $35 and $37 per month, or about 10 percent, less than the FMRS.

Past Studies Found Shopping Incentives Had Little Impact on Mobility

The section 8 existing certificate program regulations originally contained a shopping incentive feature, called a rent credit, whose purpose was to encourage families to find housing units at the lowest possible rent, thereby reducing both their rent contribution and the amount of federal subsidies required. Under the rent credit provision, a family's monthly rent contribution was reduced by the same proportion that its rent was below the area's FMR. For example, if a family rented a unit that leased for 10 percent below the FMR, the family received a 10-percent reduction in its monthly rental contribution.

In our January 28, 1977, report entitled Major Changes are Needed in the New Leased-Housing Program, we recommended that HUD not permit the payment of the rent credit to families renting in place. On May 10, 1978, we issued a follow-up report stating that additional information we obtained from contacting 31 PHAs in 20 states leads us to conclude that the rent credit should not only be eliminated for in-place families, but also for all families assisted under the section 8 program. We reported that rather than operating as an incentive to encourage families to shop for less expensive housing, only a few families actually altered their housing choice because of it.

In November 1978, HUD issued a report entitled Lower Income Housing Assistance Program (Section 8): Nationwide Evaluation of the Existing Housing Program. The report stated that the rent reduction credit has not functioned as planned. It pointed out that very few certificate holders made a specific effort to obtain lower rents and that the credit was received largely by "stayers" who never searched for units. HUD's director of the existing housing division told us that the rental credit provision of the certificate program may have been too complicated for tenants to understand. Because it was not being used as intended, it was discontinued in October 1980.

During the 1970s, HUD also conducted the Experimental Housing Allowance Program (EHAP) experiment which studied how low-income families respond to various forms and levels of housing allowances. The study was the largest social experiment ever undertaken by the federal government.

In an EHAP "Demand Experiment" in the Pittsburgh, Pennsylvania, and Phoenix, Arizona, areas HUD studied a program that was very similar to today's housing voucher program. Tenants were given housing subsidies directly and, except for minimum housing quality standards, were not constrained in the type of housing chosen or the rents paid. The study was conducted over a 3-year period and involved about 50,000 families. The EHAP experiment sought data to address, among other things, the following questions:

> "Does a housing allowance program stimulate families to move?"

> "Are increased expenditures matched by similar increases in the amount of housing which families obtain?"

In its report entitled Experimental Housing Allowance Program, Conclusions, the 1980 Report, HUD stated, regarding the first question, that the EHAP demand experiment showed

> "Mobility and location of residence are governed largely by ties to relatives, neighborhoods, friends, workplaces, and schools, and are not much affected by allowance payments and . . . the effect of the allowance on mobility is small or non-existent."

Regarding the second question, the report stated that

> "Increased expenditures for housing may not always lead to corresponding changes in the amount and quality of housing that families obtain. If early in their search for a unit that passes the housing standards, a family finds one that is overpriced, it might choose to rent it rather than continue to search for a better deal."

HUD's finding on the effect of housing allowances on mobility is not surprising since it is unlikely that low-income households that receive a sizable housing subsidy would move and rent less expensive housing. Households generally rent more expensive housing when they experience increases in income, or a reduction in the price of housing. Vouchers both raise effective household income and reduce the relative price of housing. The combination of these two factors makes it very unlikely that voucher recipients would rent less expensive housing upon receipt of the voucher. Further, recent movers generally pay higher rents than those who stay in place. Thus, the best way for households to keep rental costs down is generally to continue renting the same unit.

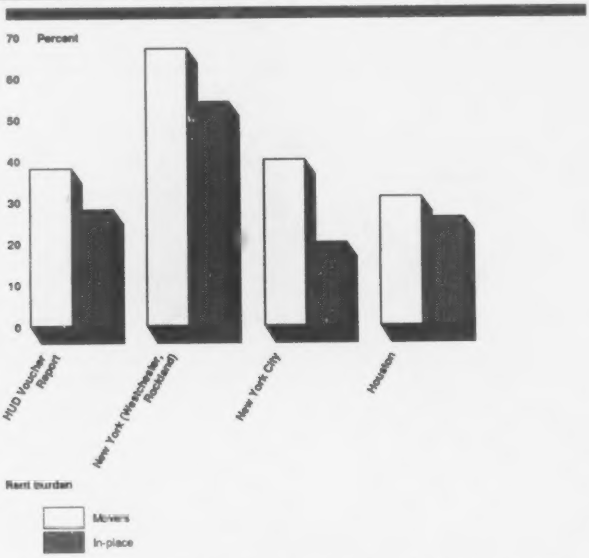
FMRs May Be Too High for In-Place Renters

In-place renters, on average, pay rents that are less than FMRs and, in the case of voucher recipients, receive larger subsidies than certificate holders and have lower rent burdens. In setting FMRs, HUD uses data from the American Housing Survey which represent a sample of units occupied by households that have moved into rental units within the past 2 years, referred to as "recent movers." Recent mover rents in the

1983 American Housing Survey were 7 percent higher than the rents of all renters.

Figure 2.4 shows, by movers and in-place rentals, the average rent burdens for all tenants included in HUD's first-year voucher demonstration program and for tenants in two-bedroom units in the Houston and New York PHAS we visited.

Figure 2.4: Voucher Tenant Rent Burdens, Movers and In-Place Rentals



In the certificate program, rent burdens generally average 30 percent of adjusted tenant income

New York is one of several states that identify a portion of the Aid to Families with Dependent Children's payment as a shelter allowance. This allowance is used as the tenant's certificate payment, regardless of the percentage of income it represents.

In New York City, certificate tenants in two-bedroom units averaged a 32-percent rent burden.

Source: PHA data and HUD's first-year report on the housing voucher demonstration.

As shown in figure 2.4, in-place renters under the voucher program have rent burdens that are less than those who move. The rent burdens for the New York counties of Westchester and Rockland represent data on a total of 55 two-bedroom vouchers that were issued between January and September 1987. Also, rent burdens in New York City were influenced by rent controls. Landlords in New York City are allowed larger rent increases when a tenant leaves an apartment than when renewing an existing lease. In New York City, from inception of the voucher program through September 1987, 68 percent of recipients receiving vouchers remained in place, and 70 percent of recipients receiving certificates remained in place. Eighty percent of the voucher families who rented in place received shopping incentive benefits—they rented for less than the FMR and received a greater subsidy than they otherwise would have with certificates.

Disparities in Current Budgeting Practices Prohibit Meaningful Cost Comparisons

Direct cost comparisons of the voucher and certificate programs are hampered by differences in the two programs' budgeting processes and the factors used to compute budgeted costs. The voucher process provides PHAS a fixed funding level over 5 years and allows no cost amendments within this period. The certificate process, on the other hand, serves a fixed number of households up to 15 years and relies on supplemental appropriations to cover cost overruns when they occur. Moreover, because HUD uses different factors in computing the cost of each program, HUD's presentation of the comparative costs of the programs in its annual housing budget justifications to the Congress is misleading.

Differences Exist in the Voucher and Certificate Budgeting Processes

Differences in HUD's budgeting for certificates and vouchers lead to tradeoffs between number of families assisted and cost controls. For certificates, federal costs can increase, but the number of families assisted and the level of assistance provided generally remain constant. Vouchers, on the other hand, are designed to hold federal costs constant, while the number of families assisted and the level of rental assistance provided can vary.

With vouchers, HUD provides PHAS with estimates of the number of families they can assist with the funds allocated to them and requires the PHAS to operate their voucher programs within these funding limits. HUD has informed PHAS that there will be no cost amendments to cover funding shortfalls. In contrast, HUD provides PHAS with a fixed number of certificates, and the funds needed to operate the program are estimated and are more flexible. PHAS are permitted to request cost amendments to cover funding shortfalls.

The Congress recently enacted a provision to enable PHAS to request additional voucher funds to cover funding shortfalls, but HUD has not implemented the provision. The Housing and Community Development Act of 1987 provides that the Secretary of HUD may set aside up to 5 percent of the total voucher budget authority as an adjustment pool.

Amounts in the adjustment pool are to ensure continued affordability when the Secretary determines additional assistance is necessary, based on documentation submitted by a PHA. The director of the housing voucher program, however, said that HUD has determined that an adjustment pool is not needed because PHAS have sufficient project reserves due to a lag between the time that voucher funding allocations are issued and housing units are actually leased to households. According to the director, an adjustment pool may not be needed for several years.

HUD has not determined, though, if all PHAS have sufficient project reserves as the program director indicated and the specific reasons why such reserves exist. For example, one reason PHAS may have such reserves is because they may be issuing fewer numbers of vouchers than HUD authorizes. Another reason might be attributed to PHAS not adjusting voucher family rent payment standards to keep up with rent inflation. Even though HUD chooses not to establish an adjustment pool, it continues to request cost amendments to cover shortfalls in the certificate program. In HUD's fiscal year 1989 budget, HUD requested $747 million in cost amendments to cover certificate funding shortfalls from prior years' appropriations.

At the PHAS we visited, we asked program officials if voucher funding, in their opinion, is sufficient to pay for the number of vouchers that HUD budgets. New York area PHA officials said they plan to issue all of the vouchers HUD provides. The officials acknowledged that funding may become a problem if the costs per vouchers increase, but if that happens, they would issue fewer vouchers in the future. PHA officials in the Houston area, on the other hand, plan to initially issue a fewer number of vouchers than the number HUD budgets. They believe it is necessary to build a reserve for unforeseen costs that may occur in the latter years of the contract period. Of the 1,319 vouchers HUD budgeted as of December 1987 to the four Houston PHAS, the PHAS plan to issue only 951 (about 28 percent less than budgeted).

The Congressional Research Service (CRS) issued a report in July 1985 entitled Preliminary Survey of Housing Voucher Demonstration Program in Large Jurisdictions, which also addressed this issue. CRS asked 20 PHAS whether the dollar amounts that HUD allots are sufficient to provide the numbers of units that HUD announced it would support. CRS found wide variations among PHAS, ranging from those that planned to issue all of the HUD allotted vouchers to those planning to issue only 56 percent of the HUD-allotted vouchers. In total, HUD-allotted 4,588 vouchers to the 20 PHAS CRS surveyed, and the PHAS projected they will issue 4,058, or 530 (11.6 percent) fewer vouchers than HUD allotted.

Our cost estimates are based on actual tenant rents and PHA subsidies, projected over comparable 5-year periods and using consistent budgeting assumptions for both the certificate and voucher programs. If HUD's budgeting assumptions do not accurately reflect future costs, differences in the budgeting processes of the two programs could affect the cost comparison. In the certificate program, PHAS could request additional program funds to cover shortfalls, potentially causing certificate costs to increase. In the voucher program, PHAS are currently not permitted to request additional funds. However, there would be other offsetting effects. If voucher funding is inadequate, PHAS could either issue fewer vouchers, in which case unit costs per voucher would increase, or PHAS could pass cost increases on to low-income families. In some cases such as in Westchester and Rockland Counties, New York, where average voucher family rent burdens for two-bedroom apartments already average 67 percent of income (see fig. 2.4), any future rent burden increases could be an extreme hardship.

HUD's Comparison of Program Costs Is Misleading

HUD's budget justifications have consistently indicated that vouchers are less expensive than certificates. For example, HUD's fiscal year 1985 budget, which first included the housing voucher program, proposed to "replace the existing certificate program with the more effective and less costly housing voucher program." The fiscal year 1989 budget continues to indicate that vouchers are less costly. The estimated 1988 per-unit cost of new vouchers, including PHA administrative fees, is $4,773, while the per-unit cost of existing certificates is $5,659.

Per-unit costs shown in HUD's budget justifications are misleading because HUD uses two different budgeting approaches. In the certificate program, HUD uses a rather straight-forward approach to compute budget authority. Specifically, estimates are based on the total number of units to be funded, multiplied by the most recent FMR per unit and the program's 15-year budget authority. HUD does not, however, include estimates for other factors that have a significant impact on the 15-year cost of the units under the certificate program. These factors include the anticipated percentage of the certificates that will be in use at any one time, the estimated amount that the tenants contribute to the rent, the rent increases due to inflation over the 15-year period, and the amount of funding the PHAs receive from HUD to cover their costs of administering the program.

Conversely, HUD uses more relevant information to compute budget authority for the voucher program. This authority is computed over a 5-year budget period and considers tenant rent contributions, which significantly decrease costs, as well as PHA fees and estimated rent inflation, which increase costs. The net effect of these factors makes the voucher program's costs appear to be lower. HUD's budget does not clarify that these different approaches were used, leaving the reader to infer that costs were computed in a similar manner. This lack of budgeting comparability makes it very difficult for policymakers to assess the true costs of the programs.

Aside from the differences in the certificate and voucher budgeting methods, another problem posed in comparing the budgeted figures for the two programs is the uncertainty over how many units the budgets can actually support. For example, in arriving at a per-unit cost for both programs, HUD estimates the number of units that can be supported with the requested budget allocation. Should HUD overestimate the number of units that can be funded, budgeted per-unit costs would be understated. Early indications are that this may be happening in the voucher program; we pointed out previously that PHAs are issuing fewer vouchers than HUD has allocated.

Similarly, actual experience has shown that HUD's budget estimates understate the cost of the certificate program. In an April 18, 1988, report,[1] we stated that HUD's budgeting approach for certificates underestimates the amount of funds needed over the 15-year budget authority period because it does not compute the cost of all factors having an impact on the program. We estimated a potential shortfall of between $2.1 billion and $11.8 billion in the budget authority needed to support the approximately 800,000 outstanding existing certificates. To address this problem, we recommended that HUD develop budgeting procedures that compute and annually update costs, for existing and new certificates, based on total program costs, including certificate usage rates, tenant contributions, rental increases, and administrative fees.

---

[1] Housing Programs: Funding Approach for HUD's Section 8 Certificate Program Needs Changing (GAO/RCED-88-136, Apr. 1988)

Converting Existing Certificates to Vouchers Is a Potentially Costly Proposition

Our cost analysis shows that it would be considerably more expensive to refinance expiring section 8 housing assistance contracts with vouchers than it would be to refinance them with certificates. Certificate tenants who have been in the section 8 program for several years generally are paying rents that are well below FMRS. Converting these certificates to vouchers would mean that rental assistance subsidies would be based on FMRS, instead of the assisted tenants' lower actual gross rents. This conversion would convey greater subsidies to these tenants and consequently reduce their rent burden below 30 percent.

Projected Cost to Convert Certificates to Vouchers

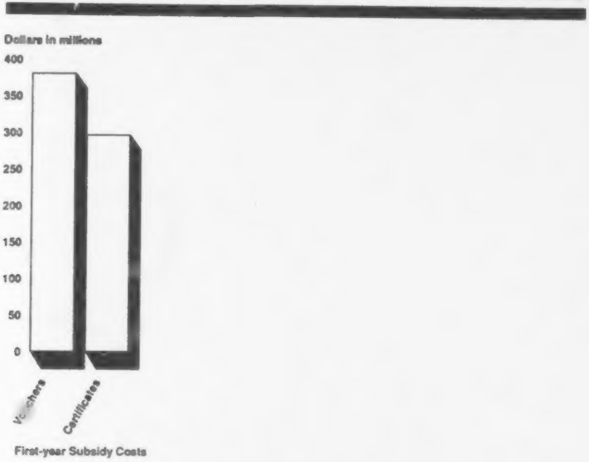
HUD's fiscal year 1989 budget justification requests authority to convert all section 8 assistance to vouchers as the current contract terms expire. Beginning in 1989, HUD's 15-year commitments to the section 8 existing certificate program—currently 780,000 units—will start expiring. Over the next 12 years, according to HUD budgeting assumptions, the costs to refund these commitments with vouchers will total $43.5 billion.

In preparing its fiscal year 1989 budget justification, HUD assumed that certificates would be replaced by vouchers and that the Congress would renew the vouchers for successive 5-year terms as they expire during the 12-year period. For example, HUD estimated that the 993 certificates that expire in 1990 would be funded with vouchers in that year and that these vouchers would again be renewed as their 5-year terms expire in 1995 and in the year 2000.

Rents of Certificate Tenants Are Below FMRs

Because vouchers convey a larger subsidy to low-income households renting below FMRS, it would cost considerably more to refinance the expiring certificates with vouchers. Data that we obtained from 17 PHAS nationwide show that rents of existing certificate tenants who were in the program as of December 1987 were 15 percent less than current FMRS. These lower than FMR rents compare with data from HUD's first-year housing voucher demonstration study which shows that rents of new entrants into the certificate program are 8 percent less than FMRS. Figure 2.5 shows the first-year subsidy costs of refinancing existing certificates with vouchers at these 17 PHAS. If expiring certificates were refinanced with new certificates, the cost would be $297 million versus a cost of $380 million if they were refinanced using vouchers. This additional subsidy totaled $83 million, or 28 percent, greater than if families continued to be assisted with certificates.

Figure 2.5: Refinancing 87,000 Existing Certificates With Vouchers Would Increase First-Year Federal Subsidy Payments by $83 Million



Seventeen PHAs nationwide provided us with subsidy cost data on the 87,000 certificates.

If expiring certificates were converted to vouchers at the 17 PHAs, voucher subsidies in the first year of conversion would be 28 percent more expensive than certificate subsidies.

Source: GAO calculations using data from 17 public housing authorities.

The costs shown in figure 2.5 are the first-year subsidy cost differential in converting certificates to vouchers at the 17 PHAS. Although the database for the 17 PHAS includes about one-tenth of the total certificates currently outstanding, it is not statistically projectable. Nevertheless, to illustrate the potential budgetary impact if the differential were applied to all expiring existing certificates, as detailed in appendix I, we calculated the conversion cost differential for the entire universe of certificate holders. Our calculations show that, if the PHA data were projectable, it would cost an additional $9.6 billion (25 percent more) if the 780,000 existing certificates that will be expiring through the year 2000 were refinanced with vouchers. This cost differential, expressed in terms of its present value, equals $4.3 billion. We used a long-term discount rate of 9 percent in this computation, which approximated federal long-term interest rates as of April 1988 on U.S. Treasury notes and bonds.

Inaccurate Fair Market Rents Affect Program Costs and Tenant Rent Burdens

In establishing FMRS, HUD uses the best available national data sources. However, because these data are not always current, inaccurate FMRS can result. Inaccurate FMRS, in turn, can lead to tenant rent burdens in the voucher program that are either too high or too low. Also, inaccurate FMRS cause federal subsidy payments to be too high or too low for both voucher and certificate recipients. Inaccurate subsidy payments either afford recipients the opportunity to rent housing beyond modest means or impair their ability to locate suitable housing.

Because FMRS set the basis for voucher subsidy payments and also the rent ceiling under the certificate program, it is crucial that HUD's determinations of FMRS be accurate reflections of rents prevailing in communities. By monitoring PHA experiences with vouchers and certificates in terms of low-income families' ease or difficulty in locating affordable housing and the rent burdens of voucher recipients, HUD would have additional information to supplement data currently used in establishing FMRS, which should improve the process.

FMRs Are Not Always Accurate

Report issued in 2/89 on Vouchers/Certificates

HUD's intent in setting FMRS is to reflect costs of modest rental housing available in the private market. The success of HUD's Division of Economic Market Analysis, under the Assistant Secretary for Policy Development and Research, in meeting this objective, is largely dependent upon the accuracy of its data sources. Because the data sources discussed below have limitations, HUD relies on public comments to identify market areas where its estimates can be improved.

HUD uses three data sources to set FMRS for 2,760 market areas nationwide—the decennial census, the American Housing Survey, and the consumer price index (CPI). The census, conducted once every 10 years by the Bureau of the Census, is the baseline for setting FMRS in 2,706 of the 2,760 market areas. Baseline rents are to reflect the price that renters who have recently moved paid for modest rental housing. In setting fair market rents, HUD also uses data from the American Housing Survey. This survey, which is done for HUD by the Bureau of the Census, provides housing data to establish the baseline rents for 54 metropolitan areas individually surveyed. The survey is also used to adjust the census data base, since it provides better information than the decennial census on housing units suitable for the section 8 program. In addition, to account for annual rent inflation, HUD uses the CPI to adjust the fair market rents for new units and to establish annual rent adjustments for units already under the section 8 program.

Because the available central data sources that HUD uses are not current or geographically specific, its schedules of FMRs and its annual adjustments do not precisely reflect rent changes in all market areas. For example, the decennial census is about 5 years old when HUD first receives the information and as much as 15 years old when a new census becomes available. Similarly, the American Housing Survey's samples for the 54 metropolitan areas provide new baseline information once every 3 to 4 years. In addition, annual adjustments for local rent inflation and housing quality are based on CPI and American Housing Survey data that are not geographically specific. Also, CPI statistics are about 1 year old when HUD publishes its FMR schedules.

HUD recognizes that because of the limitations of available data, the allowable rents that it establishes may not accurately reflect market conditions in all areas. Consequently, HUD's procedures provide for appeals of FMRs when interested parties believe these rent estimates can be improved. Under the procedure, interested parties are asked in the Federal Register to submit written evidence to HUD showing that actual rents in the community are different from HUD's estimates.

Rental Housing Is Widely Available Below the FMR Ceiling in the Houston Area

HUD field office officials and PHA officials commented that FMRs appear to be too high for the Houston market. Our contacts with landlords and visits to several rental units participating in the section 8 program showed that section 8 tenants in the Houston area have a wide choice of rental units available in almost every area, most with a variety of features and amenities, such as swimming pools, covered parking, and club room facilities.

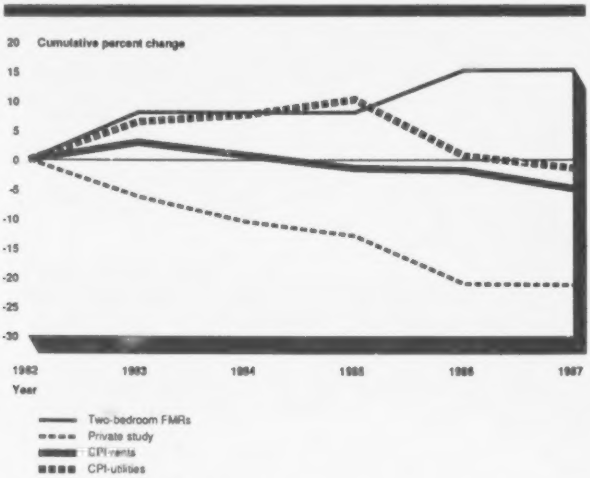
FMRs Have Been Too High Given the Depressed Housing Market

Even though HUD field office and most PHA officials believe FMRs are too high for the Houston area, HUD's procedures for adjusting FMRs rarely elicit such responses. Since PHA administrative fees are based on FMRs, respondents do not generally find it in their best interests to comment that FMRs are set higher than necessary.

Over the past 5 years HUD has increased Houston area FMRs on two occasions. An increase of 8.1 percent in 1983 reflected CPI rent and utility increases, and another 7.2 percent increase in 1986 reflected HUD's adjustments based on 1980 census data. Conversely, a 1987 apartment occupancy and rental survey, performed by a private real estate consulting firm, showed that from 1982 to 1987 residential rents have decreased by an average of 21 percent. Further, CPI data for residential rents and utilities showed an overall decline over the past 5 years.

Because the data sources used to compute FMRS lag behind current market conditions, HUD was slow to recognize the declining Houston rental market. Not until April 13, 1988, did HUD act to decrease FMRS in the Houston area. In an April 13, 1988, Federal Register announcement, HUD proposed to decrease fiscal year 1989 Houston FMRS by 3 percent. Figure 3.1 shows rent decreases in the Houston area over the past 5 years, as shown in the CPI and in the real estate consulting firm's report, and the HUD-approved FMR increases for two-bedroom units.

Figure 3.1: Comparison of FMRs With CPI and Private Rent Study in Houston Area



Source: HUD and CPI data and private rent study.

Officials from HUD's Houston field office and from three of the four Houston PHAS we visited said that Houston's FMRS are too high for the area's depressed housing market. The HUD officials noted that over the past 5 years, apartment owners have decreased unit rents by over $100 per month in some neighborhoods. They observed that FMR adjustments usually lag behind abrupt changes in rental conditions.

Plentiful Supply of Affordable Rental Housing

At the PHAS we visited, certificate and voucher applicants received a listing of landlords they could contact in shopping for housing. The PHAS generally compiled the lists based on landlords contacting them and expressing an interest in renting to section 8 tenants.

Using the lists provided by the PHAS, we contacted 40 apartment managers to determine whether they would lease to section 8 tenants. Thirty-eight of the 40 said they would participate in the program. One landlord, who would not participate, said that he had simply changed his policy and decided not to accept section 8 tenants. The other landlord said he was not familiar with the section 8 program.

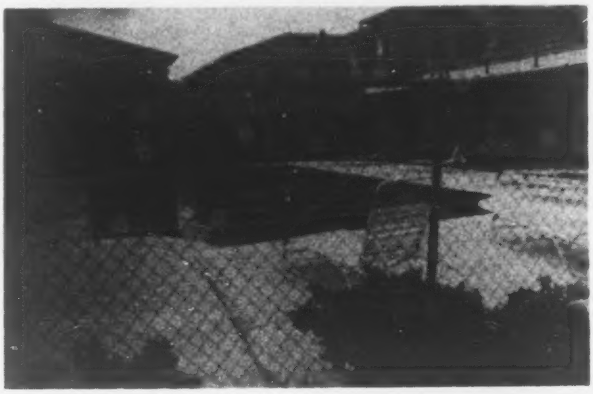
We visited 13 apartment complexes in various locations in the Houston area. Our purpose was to determine the difficulty or ease with which section 8 applicants could find acceptable rental units and to observe the type of units and locations available to certificate and voucher holders. We found that a certificate or voucher tenant could find an acceptable rental unit in almost any area of the PHA at rents below the FMR ceiling. In addition, most of the complexes offered a variety of amenities. Most complexes had swimming pools, a number had club room facilities, several were wired for cable television, one had tennis courts, and a few had covered parking for tenant vehicles. The age of the units ranged from 18 months to 25 years, and vacancies varied from 8 to 39 percent.

Figures 3.2 through 3.4 describe several apartment complexes we visited that had units available below the FMR limit. The importance of accurately establishing FMRs is illustrated partly by the fact that four families could be assisted each month in the apartment complex shown in figure 3.4, while only three families could be assisted each month in the apartment complex shown in figure 3.3. The total rent for four families living in the apartments shown in figure 3.4 would be $1,200 per month, while the total rent for three families living in the apartments shown in figure 3.3 would be $1,185 per month.

Figure 3.2: Oaks of Woodforest, Harris County PHA

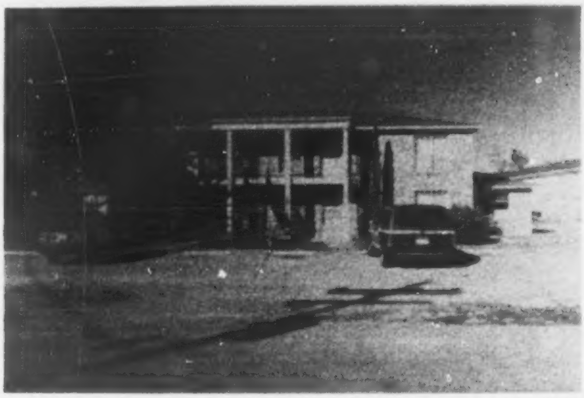
This project contained 536 units and had 3 swimming pools, tennis courts, a clubhouse, and playground areas. Two-bedroom units rented for $325 a month. Utilities, estimated by HUD at $40 per month, are paid by tenants.

Figure 3.3: Parkside Place, Pasadena PHA



This apartment complex contained 315 units and had 2 swimming pools, a clubroom, playground area, covered parking, and cable TV. Two-bedroom units were $395 per month, utilities included.

Figure 3.4: Kendlewood Apartments, Liberty County PHA



This apartment complex had 80 units. Two bedroom units, with few amenities, rented for $260 per month. Utilities, estimated by HUD at $40 per month, were paid by tenants.

Rental Units at or Below the FMR Ceiling Are Extremely Difficult to Locate in the New York City Area

PHA officials representing Rockland, Putnam, and Westchester Counties, which are included in the New York City housing market, said that FMRs for their counties are too low. However, HUD headquarters officials said that with the 20-percent adjustment, FMRs in these counties were reasonably accurate. They suggested that low vacancy rates were contributing to the difficulties low-income households have had in finding qualified units. Our contacts with landlords and visits to a number of rental units participating in the section 8 program confirmed that locating rental housing even with the adjusted FMR ceiling is difficult. Moreover, the housing that we were able to locate was very modest when compared with Houston housing and was often located in depressed neighborhoods.

FMRs for Counties in the New York City Housing Market Are Low Relative to Actual Rents

The boundaries of the New York City housing market include the entire city and the neighboring counties of Westchester, Rockland, and Putnam. Together these areas comprise the New York City Primary Metropolitan Statistical Area (PMSA). Generally, a PMSA is an area of over a million in population and has a large urbanized county or cluster of counties that demonstrate strong internal economic and social links. To meet the needs of various federal agency programs, federal standards provide for a flexible structure in defining statistical areas into various population categories. Because the population of New York City is so large relative to neighboring counties, rents in the city dominate those for the PMSA to the extent that higher rents in these neighboring counties have little impact on the FMR calculation.

The 1988 FMR for the New York City PMSA is $535 per month for a two-bedroom unit. According to the New York City section 8 program director, this FMR is adequate for New York City which has rental controls; however, the director pointed out that due to shortages of affordable rental housing, section 8 families experience problems in locating housing. Section 8 directors in the outlying counties of Westchester, Rockland, and Putnam believe FMRs are set too low for their areas. The HUD New York field office officials agree, and over the years have routinely given the counties the maximum allowable 20-percent increase to the New York FMR.[1] These increases have raised the ceiling FMR for a two-bedroom unit to $642 per month, which according to the county directors, has helped but is still too low. Westchester County officials, for example, produced a rent survey showing that moderate rents in the county were $850 in December 1987. A HUD survey of rents for two-bedroom units in Putnam County, conducted in 1986, showed that rents ranged from $600 to $850.

HUD headquarters officials said that their data show the county rent levels about 20 percent above New York City—for which the adjustment compensates. While their data (from the 1980 census) are not current, the officials said there is no evidence that the relationship between rents in New York City and the counties have significantly changed. Finally, according to these officials, there is no statistically reliable evidence that the adjusted FMRs for the counties are seriously in error.

---

[1] Under HUD guidelines, PHAs can request that HUD field offices grant exceptions to FMRs, increasing them up to 20 percent. These exceptions cannot be granted to more than 50 percent of the population of the market area.

During our review, the 1987 Housing Act established Westchester County as a separate FMR area. On March 18, 1988, HUD set a proposed fiscal year 1988 FMR for Westchester County at $642 for a two-bedroom unit. The advantage to Westchester County is that one-half of the county is now eligible to receive the 20-percent exception rent increase, which when applied to Westchester's new higher initial base would bring the FMR level for Westchester's high-cost areas to $770 for a two-bedroom unit compared with the previous maximum of $642.

We asked officials in the Office of Management and Budget (OMB), the federal agency responsible for classifying metropolitan areas, whether Putnam and Rockland counties could qualify as separate statistical areas. The officials said that the counties could be reclassified as separate areas but that the reclassification would require that favorable "local opinion" be obtained from the affected jurisdictions. According to these officials, such opinion is generally requested through the local congressional delegations, and the opinion must clearly support the separate recognition of the proposed statistical area. Concerning the New York City PMSA, OMB sent a questionnaire in February 1983 to New York City and vicinity congressional delegations concerning several PMSA restructuring proposals. The responses did not favor separating the three neighboring counties from the New York City PSMA. Accordingly, when OMB announced its final definitions of PMSAS in June 1983, Westchester, Putnam, and Rockland Counties were still included in the New York City PMSA.

OMB officials pointed out that federal agencies are not obligated to follow OMB's definitions of metropolitan statistical areas in conducting their programs. In fact, according to these officials, OMB would prefer that federal agencies establish boundaries that best relate to their individual programs. HUD views PMSAS as reasonable approximations of housing markets.

Modestly Priced Housing Is Scarce

Families provided either vouchers or certificates in the New York area have experienced considerable difficulties in locating affordable apartments. Table 3.1 shows families' success rates in locating rental units during the past 2 years. It should be noted that most of the successful families are using their certificates or vouchers to rent their current apartments. If these families were factored out, the success rates shown in table 3.1 would be even lower.

Table 3.1: Success Rates in Locating Rental Units in the New York City Area During Fiscal Years 1986 and 1987

Figures in percent

PHA	Certificates	Vouchers
New York City	32	34
Westchester County	62	57
Rockland County	34	(a)
Putnam County	36	(b)

[a] Rockland County began issuing vouchers in May 1987

[b] Putnam County did not issue vouchers

New York PHA program officials told us that higher FMRs alone will not solve New York's low section 8 utilization problem. They cited other factors as contributing causes, including: (1) a lack of affordable rental housing as indicated by low vacancy rates, (2) conversion of rental units to cooperatives and condominiums, (3) lack of new low-income rental housing construction, (4) low turnover in moderately priced apartments, and (5) adverse landlord attitudes toward section 8 tenants and program requirements.

PHAS we visited advise certificate and voucher tenants to check newspaper advertisements and to check with family, friends, and acquaintances about housing availability. The PHAS did not have lists of landlords expressing an interest in renting to section 8 tenants, as was the case in Houston. New York City, however, provided applicants with a list of landlords who currently rent to section 8 tenants.

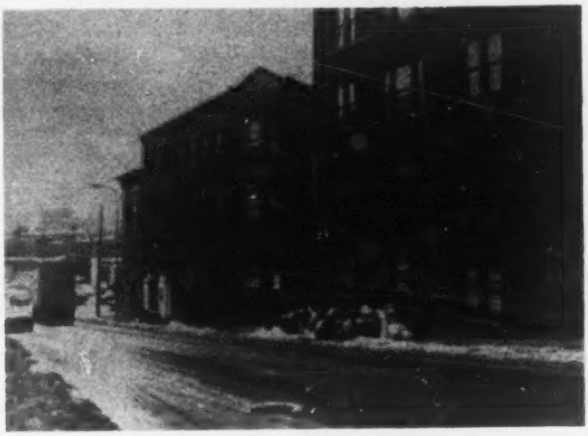
Again, using information provided by the PHAS, we attempted to locate affordable housing in the New York area. In each PHA area, we examined rental advertisements in several newspapers and rental listing publications. We also contacted several realtors. The results of our search were as follows:

- In New York City we were unable to locate any apartments whose rents were within the FMR. In addition to examining rental advertisements, we contacted landlords in the Brooklyn area who were currently renting to section 8 tenants, but none had vacancies within the FMR.
- In Rockland and Putnam Counties we were unable to locate any apartments renting within the FMR.
- In Westchester County, in addition to advising applicants to check with newspapers, family, friends, and acquaintances regarding affordable housing, section 8 counselors also provide applicants with a list of brokers who, for a fee (usually equivalent to one month's rent), will direct

them to affordable housing. We were unable to locate affordable housing in Westchester County from our newspaper and other rental listings search. One broker, however, showed us one apartment that was within the FMR and would be ready for occupancy within the next 2 weeks. The apartment was being rehabilitated.

Figure 3.5 describes the building and the apartment we were able to locate within the FMR in the Westchester area.

Figure 3.5: 75 Broadway, Yonkers; Westchester County PHA



This was a 40-unit building. The monthly rent for a 2-bedroom unit, with limited amenities, was $571 without electricity. Electricity, estimated by HUD at $25 per month, was paid by tenants.

Conclusions, Matters for Congressional Consideration, and Recommendations

Conclusions

HUD is currently operating two similar rental assistance subsidy programs—certificates and vouchers—whose identical goals are to provide low-income families with decent, safe, and affordable rental housing. The administration has proposed replacing the certificate program with housing vouchers, claiming that vouchers are less costly and more efficient. Opponents, who favor the certificate program, argue that vouchers cost more and can result in higher tenant rent burdens.

Operating one rental assistance program is logical and advantageous. It would provide a unified approach to delivering housing assistance, equalize the benefits to program recipients, and quiet the debate over which program is preferable. If the Congress elects to have one program, we believe it should consider the merits and drawbacks of features presently distinguishing vouchers from certificates and adopt those features that best satisfy the programs' legislative intent of providing decent, safe, and affordable housing.

Two key features distinguish the voucher and certificate programs. The first is the method by which PHAS provide subsidies to program recipients. Vouchers generally provide recipients with subsidies equal to the difference between 30 percent of their income and the applicable FMR. Voucher families can rent units for less than FMRS, and thereby reduce their out-of-pocket rental expenses. Conversely, voucher families can rent units for more than FMRS if they are willing to pay more than 30 percent of their income for rent. This choice, called a shopping incentive, was intended to give families a wider range of housing options and also the flexibility of spending more or less of their incomes for housing relative to other needs. The certificate program, on the other hand, provides recipients with a subsidy equal to the difference between 30 percent of their income and their actual unit rent but requires that the recipient live in units where the rent is no higher than the FMR. In contrast to vouchers, certificate recipients can neither reduce their out-of-pocket rental expenses by renting units priced below FMRS nor can they opt to pay more than 30 percent of their income to rent units above FMRS.

While we did not assess the extent to which the shopping incentive influenced family housing choices, HUD's first-year housing voucher demonstration report disclosed that households receiving vouchers were no more likely to move after receiving assistance than those obtaining certificates. Also, past studies of demand-based subsidy programs have shown that many households choose to remain in place due to ties to family, friends, employment, and neighborhoods and that a shopping incentive produced little if any influence over their housing choices.

Clearly, the shopping incentive offered to voucher recipients conveys added monetary benefits to households renting in place, at rents below the prevailing FMR, that they would not receive under the certificate program. Specifically, the rent burden for these families averaged 27.6 percent of their incomes under the first year of HUD's housing voucher demonstration rather than the 30 percent they would have paid had they received certificate assistance. This reduced rent burden, however, increases the cost of the voucher program relative to the certificate program. On the basis of the actual cost information from HUD's voucher demonstration, we project that with HUD's budget request of $3 billion for fiscal year 1989, about 9,500 (6 percent) fewer families can be assisted with vouchers than with certificates. To assist the same number of families with vouchers would cost an additional $208 million. Thus, a key policy question for the Congress in comparing vouchers to certificates is the tradeoff between providing greater benefits on average to fewer low-income households with vouchers as opposed to providing a smaller average level of benefits to more households through certificates.

The second key feature distinguishing vouchers from certificates is the budget process. Although annual per-unit costs for both programs are presented in HUD's budget, the methodology used to estimate these costs is significantly different. This difference impedes meaningful cost comparisons and could be misleading to federal policymakers.

With vouchers, HUD and PHAS are required to operate within the constraints of a 5-year authorized budget. While this is a desirable feature in the sense of promoting fiscal responsibility, it could present future problems if the budget does not accurately reflect future program costs. Should the budget understate these costs, PHAS will either serve fewer families or pass unforeseen costs on to low-income families in the form of higher rent burdens, or the Congress may be asked to fund supplemental appropriations, which has occurred under the certificate program. Although we did not evaluate the adequacy of HUD's budgeting process for vouchers, we did observe differences in the way PHAS are dealing with their funding allocations. Some have chosen to issue all vouchers allocated to them without providing a contingency reserve. Others have elected to hold back a percentage of their vouchers to better assure adequate funding in the future. Thus, under the voucher program, budgeting is driven by a fixed funding allocation, and the Congress is less certain as to how many families the program will serve over time.

Conversely, we have evaluated HUD's budgeting process for certificates and found it to be inadequate. Because HUD does not consider all program costs, it has consistently understated program needs and has had to request supplemental appropriations. In spite of this budgeting problem, the certificate program has provided continued assistance for a fixed number of families. Thus, under the certificate program, budgeting is driven principally by the number of households assisted, but the Congress is less certain as to the total costs of the program over time.

FMRS are another issue that is critical to the success of both programs. Even though HUD uses the best available centrally compiled rent data in making its FMR computations, these data have limitations. Specifically, the rent data sources that HUD uses to compute FMRS are not always current nor are they always geographically specific. Thus, FMRS may not always represent actual rents in specific neighborhoods or communities. This, in turn, can lead to inaccurate voucher subsidy payments and to tenant rent burdens that are either too high or too low. Moreover, FMRS will affect the degree of success low-income families have in locating affordable rental units under both the certificate and voucher programs. By monitoring PHA experience in terms of low-income families' ease or difficulty in locating affordable housing and tenant rent burdens, HUD would have additional information to supplement data currently used in establishing FMRS which could improve the process.

Another issue relating to FMRS is that they may be too high for in-place renters under the voucher program. Specifically, FMR computations are based on the rents of higher cost recent movers—data from the American Housing Surveys. To the extent that voucher families remain in place, their rents may be lower than FMRS, and they may receive larger subsidies than necessary to rent acceptable housing without a rent burden exceeding 30 percent of their incomes.

Apart from the debate over the desirability of relying on vouchers or certificates as the primary rental assistance program of the future, a critical policy question remains regarding how outstanding certificates should be refinanced. Beginning in 1989, about 780,000 section 8 existing certificates will begin expiring. Because certificate families who have been in the program for several years are paying rents that are substantially less than FMRS, it would be costly to change the basis of their subsidy payments from actual rents to an FMR payment standard. For the 17 PHAS we contacted, 87,000 certificate tenants were paying 15 percent less rents than current FMRS. Assuming landlords did not increase rents, these tenants would receive an additional $83 million in the first year their certificates were converted to vouchers. This, in turn, would reduce their rent burdens to under 30 percent. If these 17 agencies were representative of all PHAs, there would be a cumulative additional cost of $9.6 billion over the next 12 years to refinance the 780,000 certificates that will expire through the year 2000 with vouchers. In terms of discounted present value, this cost differential would equal $4.3 billion.

Matters for Congressional Consideration

The Congress should consider establishing one rental assistance subsidy program. In doing so, it would need to evaluate the merits and drawbacks of several features that distinguish vouchers from certificates and adopt those features that best satisfy the programs' legislative intent of providing decent, safe, and affordable rental housing. The principal differences are (1) the voucher program's shopping incentive and (2) the programs' budget processes.

Concerning the shopping incentive, if the Congress wants to keep this feature, it should recognize the limitations in the FMR process and consider directing HUD to improve the process along the lines we have discussed in this report. Moreover, the Congress may wish to consider whether shopping incentives should be paid to tenants who rent in place—especially tenants with expiring certificates. Shopping incentives are particularly significant for long-term existing certificate tenants whose subsidies will begin expiring in 1989. If the Congress wants to discontinue this feature, and base subsidies on actual rents, it may wish to consider allowing households the flexibility to rent units costing more than the FMR.

Concerning the budget processes, if the Congress wants a fixed funding allocation, similar to the voucher program, it may wish to clarify whether any funding shortfalls should be absorbed by (1) HUD establishing an adjustment pool, as presently provided for in the voucher program, (2) PHAs assisting fewer households, or (3) assisted households incurring higher rent burdens. On the other hand, if the Congress wants to assist a fixed number of households, it will want to assure that HUD provides more reliable estimates of future years' costs, as we recommended in our report entitled Housing Programs: Funding Approach for HUD's Section 8 Certificate Program Needs Changing (GAO/RCED-88-136).

Recommendation to the Secretary of HUD

We recommend that the Secretary of HUD:

- Identify areas within defined housing markets where FMRS appear to be too high or too low and make necessary, timely adjustments to the FMRS. In identifying these areas, the process of setting and adjusting FMRS should include an analysis of data from HUD field offices on tenant rent burdens, utilization rates of certificates and vouchers, and available rental market studies. Through this identification process, the Secretary may find that some of these areas are large enough to warrant their consideration as separate FMR areas. Rockland and Putnam counties are areas where FMRS may not reflect actual market conditions. The Secretary, in consultation with local officials, may wish to realign these counties into separate market areas or combine them, either with or without Westchester County, into a single market area.
- establish consistency in the budgeting processes for certificates and vouchers, as long as the two programs coexist.

Agency Comments

In commenting on a draft of this report (see app. III), HUD agreed with our conclusion that the voucher and certificate programs should be combined into a single subsidy program. It disagreed, however, with our conclusions concerning the relative costs and benefits of vouchers versus certificates—stating that our report invites the reader to draw an erroneous conclusion that certificates are better than vouchers. HUD also commented that this conclusion will be difficult to correct and only serve to prolong the development of a merged program. According to HUD, our report is based on old data collected in the first year of the housing voucher demonstration, which, according to HUD, does not consider changes in subsidy costs and rent burdens experienced in the voucher program's second year.

Our comparison of the cost and benefits of vouchers versus certificates did not, as HUD stated, rely solely on the first-year voucher demonstration study. In chapter 1, we refer to other data sources we used in our analyses. For example, in calculating the costs of converting certificates to vouchers, we obtained rent subsidy data, as of December 1987, on 87,000 certificate tenants at 13 large PHAS nationwide. Further, our report discusses the principal features that distinguish the voucher and certificate programs and how these features affect low-income tenants and program cost regardless of HUD's forthcoming second-year voucher demonstration study. HUD expects this study will show that vouchers are less costly than certificates. It pointed out that during the second-year of the voucher program, 15 of the 20 PHAs included in the demonstration did not grant rent inflation increases to low-income voucher tenants. To the extent that PHAs did not make rent inflation adjustments in the second year, voucher costs would decrease relative to certificate costs. HUD did not mention, however, that the downside of these savings are increased rental costs to be borne by low-income voucher tenants who, before the rent increases, were already paying an average of 34 percent of their incomes for rent.

HUD also said that we made two incorrect assumptions. First, it said we assumed that the voucher payment standard and the FMR are always identical and will increase by identical amounts each year over a 5-year period. According to HUD, however, this is inconsistent with the facts of the first-year demonstration study in which only 5 of the 20 PHAs increased the payment standard.

A possible explanation of why only five of the PHAs increased rents is that during the study period, PHAs were permitted to make only two rent adjustments over a 5-year period. With the passage of the Housing and Community Development Act of 1987, PHAs are now able to adjust rents annually. The annual rent inflation increases used in our analyses are consistent with both HUD's own voucher budgeting procedures and the act. HUD criticizes us for using annual rent inflation adjustments in comparing the programs, yet HUD uses identical assumptions in preparing its annual voucher budgets. Our estimates of voucher and certificate costs are made over similar benefit periods and use consistent budgeting assumptions for each program. Conversely, in preparing its budgets, HUD does not use the same budgeting assumptions for both programs, a practice we maintain misleads federal policymakers.

In the second assumption, according to HUD, we assumed that a certificate cannot be used in a unit that rents above the FMR. This assertion is incorrect. We recognize the applicable HUD regulation providing for exception rents in chapter 3 of this report. Our cost analyses in chapter 2, however, do not specifically provide for exception rents because the data used in our cost analyses were actual rents paid by both voucher and certificate tenants. Because the data were actual rents, they already include any exception rents that PHAs were providing.

It is important to emphasize that we are not taking a position favoring either vouchers or certificates but believe that the Congress should examine the merits and drawbacks of features presently distinguishing the programs and adopt those that best satisfy the programs' legislative intent. HUD did not comment on the principal features distinguishing the two programs or address the report's recommendations concerning establishing consistency in the budget process for vouchers and certificates and improving the process of setting FMRs.

Methodology Used to Estimate the Federal Costs of Section 8 Certificates and Housing Vouchers

Financial models were developed to (1) estimate and compare the costs of section 8 existing housing certificates and housing vouchers and (2) determine the impact on public housing agency (PHA) subsidy payments if outstanding section 8 certificates were refinanced with housing vouchers. The analysis considers the following factors:

- The current budgeting formulas and economic assumptions used by the Department of Housing and Urban Development (HUD) to fund vouchers and certificates.
- Costs of financing certificates and vouchers over similar benefit periods based on actual housing subsidy payments.
- Short- and long-term cost differences associated with refinancing expiring certificates based on actual subsidy payments of selected large PHAS.

Estimated Voucher and Certificate Costs Over Similar Benefit Periods

HUD budgets certificates and vouchers over different benefit periods (15 years vs 5 years, respectively) and uses different methods to estimate per-unit costs of providing housing under each form of assistance. HUD's budgeting formula for certificates is based on the average estimated FMR per unit multiplied by 15 years. Its voucher funding formula uses an FMR payment standard and also considers rent inflation and tenant contributions. HUD's administrative fee estimates are also included in the voucher budgeting formula (including three types of fees—ongoing, preliminary, and hard-to-house).

Because differences in the two programs' budgeting processes and dissimilar benefit periods hinder meaningful cost comparisons, we modified the budget formula for certificates to consider the actual housing subsidy payments, tenant rent contributions, rent inflation, and program administrative costs, similar to the voucher budgeting formula. We also used a similar benefit period (5 years) to estimate per-unit cost of assistance for both programs. This is the period for which voucher budget authority is appropriated and is the minimum term of housing assistance available with certificates (PHAS, however, may extend certificate contracts for up to 15 years).

To provide a more accurate cost comparison of the two programs, we structured our analysis based on actual certificate and voucher subsidy payments rather than HUD's budgeted cost estimates. Figure 2.2 shows the results of our analysis which uses housing subsidy cost data from HUD's first-year report on the housing voucher demonstration. Inflation rates for the analysis were derived from HUD's budgeting assumptions from 1987 to 1991, an average of about 3.4 percent per year. Gross rents for both programs are inflated annually, as are administrative fees. Voucher subsidy costs are also adjusted annually for rent inflation, as are certificates.

Our analysis further considers legislative amendments in the Housing and Community Development Act of 1987 that affect the voucher and certificate programs. Specifically, certificate and voucher PHA administrative fees were changed to 8.2 percent of the average two-bedroom FMR for both certificates and vouchers and preliminary fees are $275 for certificates and vouchers. We based our analysis on these new fee structures. In addition to these administrative fees, we account for a hard-to-house fee of $45 per unit (unchanged by the 1987 act) for both programs. The latter is applied to 20 percent of the units in accordance with HUD's budgeting assumptions.

Estimates of Households Served Based on HUD's Fiscal Year 1989 Budget Request

The results of our 5-year cost analysis were used to compute the number of households that could be served through certificates and vouchers based on the $3.0 billion in funds for the voucher program that HUD requested in its fiscal year 1989 budget justification (see fig. 2.3). HUD did not request any new funding authority for the certificate program. To estimate the number of households that could be served, we divided the $3.0 billion by our 5-year subsidy cost estimates from HUD's first-year housing voucher demonstration report. The differences in the number of households served were used to estimate the incremental budget authority needed to assist the same number of households through vouchers as with certificates.

Impact of Welfare Rent Provision on Our Cost Analysis

Our 5-year analysis also estimated the impact of welfare rent payment rules on certificate and voucher program costs. In HUD's voucher demonstration, subsidy payments to certificate families in New York and Michigan were influenced by welfare rent payment rules. In these states, the tenant rent contribution in the certificate program is the larger of 30 percent of adjusted income, 10 percent of gross income, or the portion of the welfare payment designated as rent. The voucher program does not include a welfare rent provision. We adjusted our 5-year subsidy costs for certificates to exclude welfare rent payments, according to HUD-reported data.

Estimated Cost to Refinance Expiring Existing Certificates With Vouchers or New Certificates

This analysis estimates the first-year budgetary impact of converting 87,000 existing certificate households nationwide to vouchers. We use the results of this analysis to illustrate the potential long-term budgetary costs of converting the universe of 780,000 certificate contracts that will expire over the next 12 years.

First-year costs of converting certificates to vouchers are based on actual housing subsidy cost data from 17 PHAS we contacted nationwide. The data obtained include FMRs by bedroom size and average gross rents, tenant payments, and PHA subsidy payments. Sixteen PHAS provided us with information as of December 31, 1987, and 1 PHA as of December 1, 1987 (see app. II). We aggregated the PHA data according to the number of units by bedroom sizes to arrive at weighted per-unit cost averages of the outstanding certificates. We then computed average annual, per-unit subsidy costs for vouchers, changing the payment standard for the 87,000 units from an actual rent basis to an FMR-based standard.

The 17 PHAS were judgmentally selected on the basis of their geographical dispersion and because they could readily provide us with housing cost data. For this reason, our database for the PHAS cannot be projected with statistical reliability. However, the database encompasses about one-tenth of the total certificates currently outstanding.

The second part of our analysis calculates the potential budgetary impact of converting the expiring HUD certificates to vouchers, using as a baseline the certificate and voucher subsidy costs from our PHA database. We used the assumption HUD used in its fiscal year 1989 housing budget justification, that is, that all certificates would be replaced by vouchers and that the Congress would renew the vouchers for successive 5-year terms as they expire during the 12-year period. For example, HUD estimated that the 993 certificates that expire in 1990 would be refunded with vouchers in that year and that these vouchers would again be renewed as their 5-year terms expire in 1995 and in the year 2000. Because of this overlap, about 1,359,000 units would be refinanced through the year 2000.

Our long-term refinancing cost computations use a budgeting formula similar to vouchers because this method takes into account future rent inflation, administrative costs, and a 5-year budget authority period. According to this formula, our baseline (1987) per-unit subsidy cost estimates are adjusted to allow total rent increases of 15 percent over a 5-year period. PHA subsidy costs and ongoing administrative fees incurred in subsequent years (1988 to 2000) are inflated according to annual factors that HUD's housing budget office provided us.

We also calculated the present value of the cost of certificate and voucher refinancing from 1988 to 2004. This is the time frame over which the successive 5-year increments of allocated budget authority would be obligated. For purposes of discounting, costs were weighted by the year in which they are obligated. A discount rate of 9 percent was used, which approximated the federal long-term interest rates as of April 1988 on U.S. Treasury notes and bonds.

PHAs Providing GAO With Information Used to Estimate the Cost of Converting Existing Certificates to Vouchers

Public Housing Agency

City of Atlanta Housing Authority
Atlanta, Georgia

Baltimore City Housing Authority
Baltimore, Maryland

Boston Housing Authority
Boston, Massachusetts

City of Pasadena Housing Agency
Pasadena, Texas

Dallas Housing Authority
Dallas, Texas

Georgia Residential Finance Authority
Atlanta, Georgia

Harris County Housing Authority
Houston, Texas

Housing Authority, City of San Diego
San Diego, California

Jacksonville Department of Housing and Urban Development
Jacksonville, Florida

Liberty County Public Housing Authority
Liberty, Texas

Maryland Department of Housing and Community Development
Baltimore, Maryland

Milwaukee City Housing Authority
Milwaukee, Wisconsin

New York City Housing Authority
New York, New York

Oakland Housing Authority
Oakland, California

Oklahoma City Housing Authority
Oklahoma City, Oklahoma

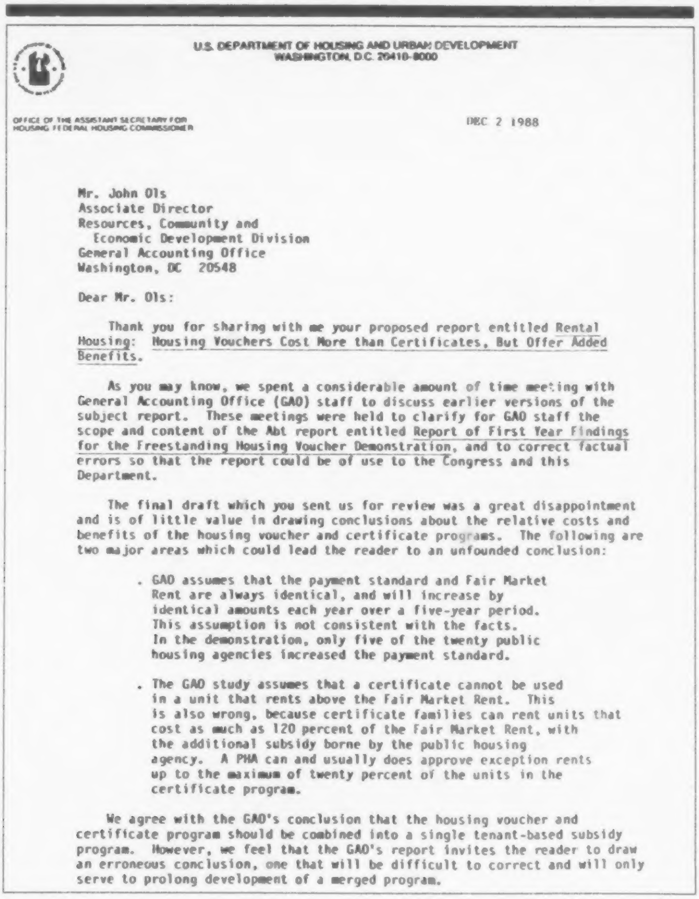
Orange County Housing Agency
Irvine, California

Riverside County Housing Authority
Riverside, California

Note: The PHAS provided data on certificate recipients as of December 31, 1987, except for New York City, which provided data as of December 1, 1987.

Appendix III

Comments From the Department of Housing and Urban Development



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING FEDERAL HOUSING COMMISSIONER

DEC 2 1988

Mr. John Ols
Associate Director
Resources, Community and
  Economic Development Division
General Accounting Office
Washington, DC 20548

Dear Mr. Ols:

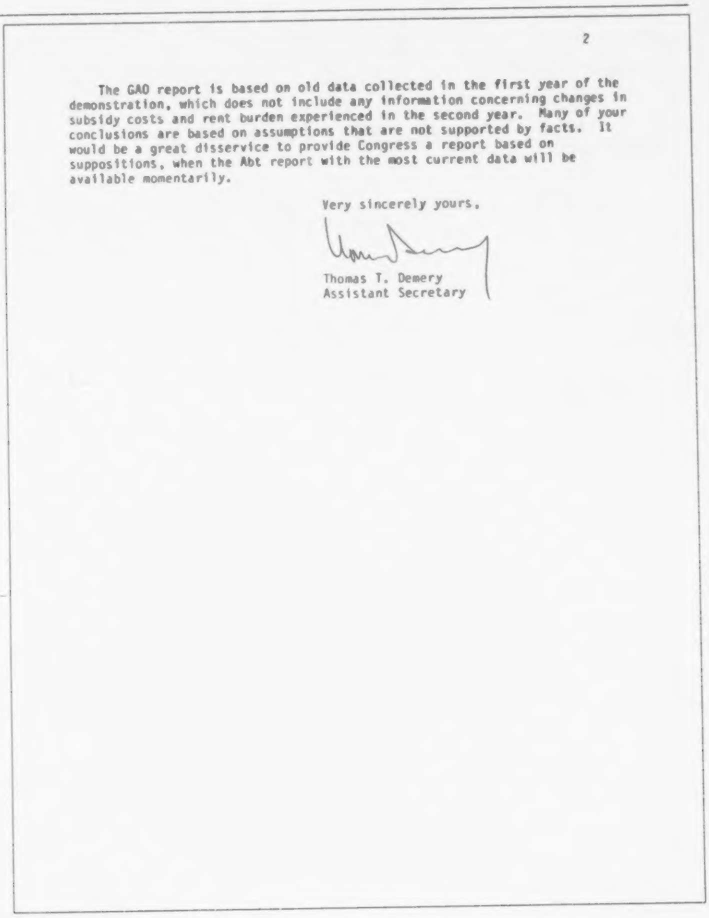
Thank you for sharing with me your proposed report entitled Rental Housing: Housing Vouchers Cost More than Certificates, But Offer Added Benefits.

As you may know, we spent a considerable amount of time meeting with General Accounting Office (GAO) staff to discuss earlier versions of the subject report. These meetings were held to clarify for GAO staff the scope and content of the Abt report entitled Report of First Year Findings for the Freestanding Housing Voucher Demonstration, and to correct factual errors so that the report could be of use to the Congress and this Department.

The final draft which you sent us for review was a great disappointment and is of little value in drawing conclusions about the relative costs and benefits of the housing voucher and certificate programs. The following are two major areas which could lead the reader to an unfounded conclusion:

- GAO assumes that the payment standard and Fair Market Rent are always identical, and will increase by identical amounts each year over a five-year period. This assumption is not consistent with the facts. In the demonstration, only five of the twenty public housing agencies increased the payment standard.
- The GAO study assumes that a certificate cannot be used in a unit that rents above the Fair Market Rent. This is also wrong, because certificate families can rent units that cost as much as 120 percent of the Fair Market Rent, with the additional subsidy borne by the public housing agency. A PHA can and usually does approve exception rents up to the maximum of twenty percent of the units in the certificate program.

We agree with the GAO's conclusion that the housing voucher and certificate program should be combined into a single tenant-based subsidy program. However, we feel that the GAO's report invites the reader to draw an erroneous conclusion, one that will be difficult to correct and will only serve to prolong development of a merged program.



2

The GAO report is based on old data collected in the first year of the demonstration, which does not include any information concerning changes in subsidy costs and rent burden experienced in the second year. Many of your conclusions are based on assumptions that are not supported by facts. It would be a great disservice to provide Congress a report based on suppositions, when the Abt report with the most current data will be available momentarily.

Very sincerely yours,

Thomas T. Demery
Assistant Secretary

Appendix IV

Major Contributors to This Report

Resources, Community, and Economic Development Division, Washington, D.C.

John M. Ols, Jr., Director, Housing and Community Development Issues
(202) 275-6111
Dennis W. Fricke, Assistant Director
Robert J. Tice, Evaluator-in-Charge
Victor J. Sgobba, Staff Member
Richard Cooperstein, Advisor

Dallas Regional Office

Frank Borkovic, Regional Assignment Manager
Joseph M. Raple, Site Senior

New York Regional Office

Robert A. Barbieri, Regional Assignment Manager
Cornelius W. Donovan, Site Senior
Kevin M. Kumanga, Site Senior
Mary Sokoloski, Staff Member
Michael C. Sloan, Staff Member

Mr. **Greer**. Senator, one other point. That's what this chart is trying to show you. The yellow bar is subrehab and new construction fair market rents, which are computed by HUD on an annual basis in much the manner that Mr. Terner just talked about. That is, HUD people go out in the marketplace and determine what the cost of new construction units should be today. Then they trend it forward 2 years. So you can see in at least four market places, the yellow is considerably less than the blue, meaning that the new and subrehab are even lower than the section 8 existing.

I think that demonstrates that there is a lag in the existing rent computation.

Senator **Graham**. It was mentioned that the availability of low-income tax credits is not factored into the determination of what is fair rent. Why is it not factored in?

Mr. **Adams**. That was an issue we raised in our audit, Mr. Graham, and recommended to the Department that prospectively that be done. Again, it's a situation which they had never perceived as part of their responsibility.

Senator **Graham**. They did not perceive it as part of their responsibility to assure that the fair market rents were what the name implies relevant to the market, and fair to the developer?

Mr. **Adams**. I thought your question was on the low-income tax credit.

Senator **Graham**. It was. But, since the data that have been submitted clearly indicate that the addition of those low-income tax credits substantially affected the financial viability of these projects, for HUD to ignore that is to cause HUD to not achieve its goal of establishing fair rents.

Mr. **Adams**. I agree, yes. We felt that they should be considered, both of those, to determine what the total public benefit was being placed in them. They have not in the past. That's going to be one of the things that is considered prospectively.

I think some of the proposed legislation would actually require that to be done also.

Senator **Graham**. We've been joined by Senator Cranston, chairman of the Housing Subcommittee of the Banking Committee.

Senator, did you have any comments?

Senator **Cranston**. No, I don't at this point. I'm not tuned in yet to what you're doing. Thank you.

Senator **Graham**. Senator, we are on the second of two panels. The two members of the first panel have continued to be with us. We are discussing various analyses that have been recently completed of the developers' profits, how rent structure was established, low-income tax credits and an issue that I'd like to go to now. That is the role of the coinsurer.

When did the use of coinsurers become standard operating procedure?

COINSURERS

Mr. **Greer**. 1985.

Senator **Graham**. Prior to 1985, how was the process managed within HUD?

Mr. **Greer**. Not all Mod Rehab projects are coinsured by any stretch of the imagination. But, for the last 2½ years, we noted that about 50 percent of all Mod Rehab projects are, in fact, coinsured.

But, prior to that time, you could have projects insured by HUD itself, fully insured projects. But, for the most part, the owners found conventional financing.

Senator **Graham**. What benefit did the developers secure by having coinsurance?

Mr. **Greer**. We issued an audit report in March 1989 concerning 14 projects coinsured by Benton Mortgage Co. In all 14 cases, we commented on the manner in which those projects were underwritten and stated that we believed that the rents were artificially kept high by Benton Mortgage Co., either in concert with or at the request of the mortgagor.

And a lot of those projects were in the soft areas. What that bottom line means is that the HUD subsidies were excessive by tens of millions of dollars for the 14 projects that we looked at.

Senator **Graham**. So, the principal benefit of coinsurance for the developer was not the insurance aspect, but rather the opportunity for the coinsurer to get excessive rental rates established.

Is that right?

Mr. **Greer**. That's right. Plus, he has a guaranteed mortgage, a nonrecourse mortgage. There are several advantages to having HUD financing.

Senator **Graham**. If those benefits were so apparent, why were 50 percent of the Mod Rehab projects not coinsured?

Mr. **Greer**. I can't answer that. We didn't look at those that were not.

Senator **Graham**. Could you go back to the question, and this is a question that anyone who would like to can contribute:

What did the coinsurer do that resulted in higher rents that would not have occurred in those other 50 percent of the projects where there was not a coinsurer?

What did the coinsurer contribute to ballooning the rents?

Mr. **Greer**. One of the main criticisms of our report was that the coinsurer was allowed to do the rent computations wherein most situations, like Ms. Truett discussed, PHA's should be calculating of the Mod Rehab rent. She was showing you earlier the formula that you have to go through.

Well, when coinsurance was involved, because of some confusion with the HUD guidance, coinsurers came to a PHA and said, "You don't need to make that computation because it's a coinsured loan. We've been delegated that responsibility."

That happened in many, many cases. So, in effect, what you had was the coinsurer acting as an agent for HUD establishing the rents without any HUD controls, and in a lot of cases, without any PHA involvement at all.

They were really in control of the whole situation.

Mr. **Schussheim**. And, sir, that insurance was validated by the section 8 rents; the subsidies that were paid made sure that the excess valuations that were placed on properties could be carried, the debt service could be covered and the operating expenses would be paid for by the Federal Government through the section 8 program.

Senator **Graham**. Yes, Ms. Truett.

Ms. **Truett**. I might add, Senator, at the local level, at least in Jacksonville, even if that were the case, we did go over the rents, and we did go over them in detail using the form that I showed you earlier. And we did that in conjunction with the staff from the field office.

So we were aware when rents were jacked up. We were very aware of it. And, generally, in our case anyway, we knocked them down.

Senator **Graham**. Ms. Truett, what has been the experience in your area of the use of coinsurance in Mod Rehab?

Ms. **Truett**. Perhaps because we are a little more sophisticated in maybe some other areas in determining these rents locally, that has not been used very often.

Senator **Graham**. I note that one particular firm, Benton Mortgage, seems to be disproportionately involved in these coinsurance projects.

Do you have any explanation of why? Where is that firm headquartered?

Mr. **Greer**. Knoxville, TN.

Senator **Graham**. Tennessee was not a State that showed up particularly as having a large number of these projects, was it?

Mr. **Greer**. No. But, Benton Mortgage Co. is a subsidiary of an old line lender called Benton and Company. They had for many years, starting in the mid-seventies, been involved in rehabilitation financing of other section 8 programs.

So they had a great deal of experience in the rehab area.

When we interviewed them, they said that that was their niche in the marketplace.

Senator **Graham**. Any other explanations of why they were used so predominantly?

Mr. **Greer**. Well, we say in the audit report that I mentioned earlier that developers or mortgagors would gravitate toward Benton because the mortgagors got what they sought. That is: a maximum mortgage.

Senator **Graham**. Did Benton have any pattern of a relationship of its employees or executives from previous service in HUD?

Mr. **Greer**. Not a great deal. We are aware that several former HUD employees do in fact work for Benton Mortgage Co., but they're not at the high management level.

One individual, the chief underwriter, was a former HUD employee in the Chicago Regional Office in a similar capacity. And a couple of their appraisers were also former HUD appraisers.

But, at the higher levels, I'm not aware, you know, the management, the president on down, I'm not aware that they were former HUD employees.

Senator **Graham**. Turning to the comment, Ms. Truett apparently in her office, the rent allowance is then reviewed by the local public housing authority.

What is the pattern in other communities?

Mr. **Greer**. That's what's supposed to happen. Again, our national report criticized many PHA's for not doing that job, number one, or not doing it well, number two.

Jacksonville was not one of the PHA's that we did review.

Senator **Graham**. Senator Cranston.

Senator **Cranston**. I'd like to ask whoever would be the appropriate person to answer some questions about the impact on the poor of housing benefits that a responsible developer could produce for the use of low-income housing taxpayers.

First, looking at the Mod Rehab Program itself, in some instances, well-connected developers got Mod Rehab assistance for projects in real estate markets that had collapsed with high vacancy rates and falling rents.

They also got unusually high fair market rents which determined the monthly payments from HUD.

If HUD approves an excessively high fair market rent, a subsidy equally excessive amount of budget authority must be used for housing in the project.

That's correct, isn't it? You all nod your heads in agreement.

Am I correct in thinking that if a 100-unit apartment building is allowed fair market rents that are 10 percent above what they should be, that means that 10 fewer units of affordable housing will be produced?

Mr. **Adams**. That's approximately correct.

EXCESSIVE FAIR MARKET RENTS

Senator **Cranston**. So we're not talking about abstractions here. That means that 10 more low income families are today on the waiting list, or today are homeless because of these excessive fair market rents.

Mr. **Schussheim**. Excessive contract rents that were approved on those projects.

Senator **Cranston**. I beg your pardon?

Mr. **Schussheim**. I would say excessive contract rents approved for those specific projects.

Senator **Cranston**. Can you estimate for us how many additional units could have been produced if the rents had been more reasonable on the projects selected by GAO?

Mr. **Ols**. We did not make that estimate. We would be glad to provide it for the record. We did have a hypothetical case where we showed you could get an additional two units, one to two units, automatically if you just reduced that tax credit.

But we'd be glad to project that out. We just did not do that, Senator.

Senator **Cranston**. If you would do that for the record, we would appreciate it.

Note: GAO will provide this information in its final report to the committee.

Senator **Cranston**. Who are the new consultants identified by the inspector general's survey?

Mr. **Adams**. I'll try to read those for you, Senator Cranston.

Daniel Hughes, Phillip Abrams, Barrett, Montgomery, and Murphy, Carla Hills, Paul Manafort, Bill Taylor, Lou Kitchen and Jeris Leonard.

Senator CRANSTON. Who is the next to last one?

Mr. ADAMS. Lou Kitchen.

Senator CRANSTON. Did you find additional consultant fees that have not previously been revealed up until now in the press?

Mr. ADAMS. I believe we did. I think Mr. Hughes is one that quickly comes to mind.

Senator CRANSTON. Can you give us any details on who and how much was involved?

Mr. GREER. As Paul just mentioned, Mr. Hughes got $145,000 from a developer who told us it was for one or two projects. He wasn't very specific with the information.

Previously, we had not identified the law firm of Barrett, Montgomery and Murphy; as a consultant, they received $83,400 from a developer.

Phil Abrams, the Phillips Development Corp., which we had previously known to be involved as an owner, also received consulting fees from a developer in North Dakota. Paul Manafort, who has testified before the House Subcommittee, and had been identified in the media, was not identified when we originally did our sample, as well as Mr. Taylor, Bill Taylor, Jeris Leonard is an attorney in town and was also identified as a consultant on one project and received a retainer of $5,000.

The developer told us when we spoke to him by phone that, although there's a higher billing, he was not going to pay it because of all the recent media attention to the consulting issue.

Senator GRAHAM. Well, somebody benefited. [Laughter.]

Senator CRANSTON. Who are the developers for each of the GAO projects?

Mr. OLS. I went into that, Senator.

Senator CRANSTON. Tell us where they're located also.

Mr. OLS. Maybe Paul Adams can help me out a little bit on that. OK. The first project, and these are all our pro formas and they're listed in my detailed statement.

No. 1, was Windsong, Tulsa, OK. The developer was the Winn Group.

No. 2, was Sierra Pointe, Clark County, NV, also the Winn Group.

No. 3, was Cleveland Gardens in Las Vegas, NV. The developer was B.R. Scott.

No. 4, was Sierra Vista, Denver, CO, which is the example I used during my testimony. That was the Winn Group also.

No. 5, was West Dade, that's Dade County, FL, the developer was A. Martinez.

No. 6, was Baltimore Gardens, Las Vegas, NV, B.R. Scott was the developer.

No. 7, was Pebble Creek, Arlington, TX. The developer was Carmen and Muss.

No. 8, was Sun Gardens, Tulsa, OK. B and C Partnership.

Paul, do you have any others that I missed?

Mr. ADAMS. I think that covers it.

Senator **Cranston**. Could you tell us what the total profit of the Winn Abrams Group has been for the selected projects.

Mr. **Ols**. The total?

Senator **Cranston**. The total profit made by Winn Abrams for the selected projects.

Mr. **Ols**. I would have to make a quick addition, but I think about $5.8 million, a quick addition of my figures here takes it to $5.8 million on three of the eight projects.

Senator **Cranston**. $5.8 million?

Mr. **Ols**. I think he may be involved in other projects.

Senator **Cranston**. Do you have any list of other projects they were involved in?

Mr. **Ols**. I do not.

Mr. **Greer**. Yes, sir. We know that they're involved in at least four other projects. We could provide that for the record.

Senator **Cranston**. Would you provide that for the record?

[Information furnished:]

SUMMARY OF WINN—ABRAMS SECTION 8 MOD REHAB PROJECTS

[Dollar amounts in millions]

Project name and locations	Public housing agency	No. of units	Budget authority	Insured mortgage	Tax credits
Rolling Green Edmond, OK	Oklahoma Housing Finance Agency	166	$15.0	$5.0	$3.9
Sierra Vista Aurora, CO	Colorado Housing Finance Agency	209	24.0	6.5	4.4
Windsong Apts Tulsa, OK	Tulsa, H.A.	202	18.1	5.8	4.4
Indian Springs Broken Arrow, OK	Oklahoma Housing Finance Agency	261	22.0	9.3	2.4
Sierra Pointe Las Vegas, NV	Clark County H.A.	160	19.8	7.4	6.0
Windsor Court Aurora, CO	Aurora H.A.	143	15.3	4.6	3.6
Terrace Apts Oklahoma City, OK	Oklahoma City H.A.	206	19.4	5.4	4.3
Total		1,347	133.6	44.0	29.0

Senator **Cranston**. How many of these were on the list you gave us?

Mr. **Ols**. There were three.

Senator **Cranston**. So there are even more.

Mr. **Greer**. At one point, we computed the tax credits associated with those seven or eight projects, and it's about $30 million. That doesn't mean that they're going to receive the $30 million.

Senator **Cranston**. Over how many years was that?

Senator **Graham**. That is the tax credits.

Senator **Cranston**. How many years?

Mr. **Greer**. It was a period of about 2½ years.

Senator **Cranston**. Thank you very much. I have no further questions.

Senator **Graham**. I've been informed that in one of the cases, in Clark County, NV, that the local public housing authority did review the rents that were submitted by the developer through the coinsurer and considered them to be excessive. That local PHA requested HUD for guidance, but there was no response from HUD until 1 year after the project was under construction.

Are you familiar with this experience in Clark County, NV?

Mr. **Ols**. I am not.

Mr. Greer. I believe I'm familiar with that. I agree with what you just said. It's absolutely correct, yes, sir.

Senator Graham. Is that an aberration, or were there other PHA's that had a similar experience of attempting to exercise some oversight similar to that which Ms. Truett has described in Jacksonville, and were unable to do so due to lack of cooperation from HUD?

Mr. Greer. My guess would be, in the 14 projects that we looked at, that probably happened on 5 or 6 different occasions.

The local people or the HUD people thought the rents were much too high. But the rents were established at the higher rates based primarily on waivers granted by the Department.

Senator Graham. Could you identify which of the projects benefited by a waiver?

Mr. Greer. We'll provide that for the record.

[Information referred to follows:]

In response to a request to provide the Committee with a listing of all waivers provided by HUD in processing coinsured moderate rehabilitation projects by Benton Mortgage Company, we requested assistance from C. Austin Fitts, FHA Commissioner on August 4, 1989.

Housing Staff is in the process of researching files to locate the waiver documents. We expect to be able to provide the data by September 8, 1989.

Senator Graham. So I am clear, this waiver is granted at the regional or the national level of HUD?

Mr. Greer. The ones I'm talking about right now are waivers that were granted by the Assistant Secretary at the Headquarters level.

Senator Graham. Who was the Assistant Secretary for Housing at the time?

Mr. Greer. For most of this period, it was Tom Demery.

Senator Graham. And those waivers were waivers to what?

Mr. Greer. To allow the mortgage company to use the Moderate Rehabilitation Rents, the FMR's; as long as the rents computed by the company did not exceed the fair market rent, the Mod Rehab fair market rent, they could use them regardless of what the local people or the HUD area office people said the rent should be.

Senator Graham. But that required a waiver from the Assistant Secretary's level to do that?

Is that correct?

Mr. Greer. Yes, because regulations state that it should be at a lower amount.

Senator Graham. I think, Mr. Greer, you mentioned some confusion at HUD. What kind of confusion? What word is characteristic?

CONFUSION AT HUD

Mr. Greer. The confusion basically centered around the fact that when the Mod Rehab Program and HUD insurance were involved prior to coinsurance, HUD would always dictate what the rents would be, because HUD has some control over it and wanted to make sure that the security for the mortgage was adequate. And at the same time, had some control over what contract rents they were going to pay.

When coinsurance came into being, the ability of HUD to control the rents was lost because all the underwriting process was delegated to the coinsurer. But, HUD didn't adequately change all the guidance and the handbook instructions.

So, the people at the PHA level and even people at the HUD area office level were not certain whether the old procedures carried forward to the coinsurer.

But, oftentimes, in many cases, the coinsurer insisted that the process would remain the same, that is, the person doing the insurance underwriting would dictate what the rents should be.

When that happended, HUD had absolutely no control over the rental amounts; everything was delegated to the coinsurer.

Senator **Graham**. Didn't the coinsurer have a conflict of interest in terms of its desire to have as high a rent as possible, since the higher the rent, the less risk that they would be called upon for their coinsurance?

And they had no economic adverse consequences by these high rents which were paid by the Federal Government?

Mr. **Greer**. Yes, sir. Most of what you've said is correct. The risk really didn't change. They're only on the hook for 19 percent anyway, but the fees that they got, all the incentives were of course to drive the mortgage as high as they could.

Senator **Graham**. I would assume that they benefited, one, as a mortgage company. Probably, their reimbursement for placing the mortgage was somewhat related to the size of the mortgage.

Mr. **Greer**. Yes, sir.

Senator **Graham**. You make more money with an $8 million mortgage than a $6 million mortgage.

Mr. **Greer**. Correct.

Senator **Graham**. Second, they are guaranteeing 19 percent. They have 100 percent of the first 5 percent.

Mr. **Greer**. That's right.

Senator **Graham**. Then 50 percent of the remainder. Is that it?

Mr. **Greer**. Twenty percent of the remainder. By formula, it works out to about 19 percent overall.

Senator **Graham**. I would assume that the greater cash flow coming into the project, the more solvent the project is likely to be and, therefore, as the mortgage guarantor, the less likely they are to be called upon to have to come into a default situation.

Mr. **Greer**. That's correct. There should be no situations where a 100-percent section 8 Mod Rehab project goes into default because the Government is paying the rents for the most part.

Senator **Graham**. Mr. Terner.

You were giving me a facial message that you might want to comment on that.

Mr. **Terner**. I'm sorry. I was listening to the testimony and I didn't mean to signal you with my face.

Senator **Graham**. If you have any comments?

Yes, Senator Cranston.

Senator **Cranston**. I would like to ask you a question. First, I must say I'm sorry I hadn't been here to hear your testimony, but I hear from other Senators that you've been outstanding, eloquent, forceful, and knowledgeable.

Mr. **Terner**. These are projects in your district, Senator, so we hold them to a high standard. [Laughter.]

Senator **Cranston**. I'd like to just ask you:

What is your reaction, as a very responsible developer, to what some of these other Federal developers have been doing in terms of their profit and the money aspects of what has been involved?

REACTION TO EXCESSIVE PROFITS

Mr. **Terner**. My reaction is that it's an unspeakable affront. And I think what you're seeing here is that the Mod Rehab Program was conceived up and put into operation by HUD long before tax credits ever came out of the 1986 Tax Reform Act.

And what happened was that you had a program that essentially was conceived and I think it was a program that could have been improved, but essentially was an operable program. And what you did was see HUD come in and allow developers, unscrupulous developers, to double-dip and, in some cases, triple-dip with these coinsured mortgages and everything.

You had a program, the Mod Rehab Program, that was operable. Then, tax credits were layered on top of that and that was all gravy. That did not have to go back into the project.

The testimony earlier led to a dissection of the anatomy of two projects, of course, in California, where we had $3.1 million in tax credits for 115 tax credit eligible units, very low income units, renting at $390 a month.

That comes to $27,000 of public credit per unit. That's a 10-year contract, so that comes to $2,700 a year. Divide that by 12 and that comes to a little over $200 a month. That $200 a month can go any number of places.

And the developments that I was reporting on, the rents were reduced from $575 a month down to $390. That's $185. So virtually, all of the tax credits, virtually all of the revenue lost to the Treasury was going back into the pocket of a very low income family, who is the consumer in that development.

The cases that you're hearing about now basically, and with such fascination, I guess my jaw was dropping when I hear the GAO speak to these in these audits, you saw that same money that could have gone back to the consumer going right into an unscrupulous developer's profit and it's all being enhanced by pumped up appraisals and these very questionable relationships with mortgage companies.

The tragedy of all of this is that the work that is possible to be done and is desperately needed, as I'm sure you know, is being siphoned off and the positive work that is happening is now slimed by all of the corruption that you're uncovering here today, and that I presume will continue on into the future.

I certainly hope you don't lose the opportunity to do the valid work because everything is so negatively taken.

Senator **Cranston**. I appreciate that very much, and I agree with you. It's tragic and it's outrageous; when you say "will continue into the future," I hope you mean revelations and not corruption. [Laughter.]

Mr. **Terner**. I certainly do, yes.

Senator **Cranston**. Are you familiar at all with the National Affordable Housing Act that I and others have introduced?

Mr. Terner. I know it is the Cranston-D'Amato bill. I am, indeed, yes.

Senator Cranston. I call it the National Affordable Housing Act.

If you have any suggestions as to steps we should take in connection with this new legislation to reduce the prospects that there will be any further corruption and abuse of these programs, we'll be eager to have that.

NATIONAL AFFORDABLE HOUSING ACT

Mr. Terner. Sure. I said this briefly before, but it's painfully simple and the people who have been talking about regulating developers' profits and so on and so forth, I think what the bill does is propose a flexible competitive process, so that numbers of developers and communities and nonprofit/for profits—it doesn't matter—are coming to a dispensing agency with competitive projects.

The pro formas are there for everybody to look at and it's very easy to see where the public dollar is providing the greatest public benefit.

And that is the way. You don't have to regulate profits because everybody will want to participate in the program that's offered by the bill. So you're going to have voluntary cutting of profits. People are going to shave these deals as close as they possibly can so that the application is more competitive and it increases the likelihood of funding.

That is the way to put a cap on this thing.

The issue really is there are scarce funds. They ought to go to the meritorious projects, not to projects where you can get James Watt to make a phone call for you or whatever.

But, where the public benefit test, dollar for dollar, in terms of either deferred money to the Treasury or appropriated money by the Congress is doing yeoman's duty in terms of providing public benefit to the consumer.

Senator Cranston. Thank you very much.

Any other suggestions as to steps we should take to inhibit these kinds of developments in the future?

Mr. Ols. I would just second Mr. Terner's comments. I think he's on target. You need an oversight, seeing where the total subsidy package is going in these projects, and make sure that we make the most of what we have to provide to low-income housing.

Mr. Schussheim. Senator, I have two thoughts. Perhaps we should consider separating coinsurance from the Moderate Rehab Program. It's really questionable whether it's appropriate for a private lending company to do the underwriting on projects where the Government through section 8 is going to guarantee payments on those mortgages for at least 15 years.

Then, of course, that would require that FHA staff of underwriters be strengthened. It is not able to do the job today because today 70 percent of FHA multifamily projects are coinsured projects.

We have delegated out that function, or they have delegated out that function to the private sector.

Second, I think you might want to consider putting a cap on the amount of rehabilitation costs that are admissible under the Moderate Rehab Program. It was intended, as you know, to be a program with unit costs or perhaps $8,000–10,000. At today's costs, that might be—that was 1978—if you adjust it for inflation, perhaps you are talking about $15,000–$20,000.

But, the inspector general's estimate showed that the average rehabilitation costs on the projects they looked at was about $26,000 per unit, and some went as high as $80,000 per unit.

That would seem to be a questionable use of the program. It was not intended as substantial rehabilitation; it was supposed to be modest rehabilitation.

Ms. **Truett**. Senator, I would say that probably the most important thing to add to just everyone else has said is to provide the ongoing training, funding in HUD's budget to be able to train them sufficiently that they can do the kind of analysis that the GAO and the IG has already done for projects, to provide regular monitoring.

If you could build that into any process that comes out of the legislation by both HUD's IG as well as any of these kinds of things that go through the State process as well.

Someone needs to monitor that most definitely. And I would say last, but not least, if there was some way it would seem to me that while you cannot cookie cutter any of these deals, as we've discussed, it seems to me that you could put together a very basic program, computerize it and have that in a short but interesting way presented to teach all of the local PHA's how to do this, and perhaps the field office as well, including the State personnel that administer the tax credit program. So that you don't end up with an $80,000 unit cost.

Someone needs to look at that. And I think your bill could begin to address that, too.

Senator **Cranston**. Thank you very much. I have no further questions.

Senator **Graham**. Thank you, Senator. I'd like to follow up on the analysis that Mr. Terner did of how the income tax credits in his project contributed to reducing the rents by approximately $85 a month.

Looking at project four, which is the project that Mr. Ols has analyzed, attempting to be consistent with the analysis that Mr. Terner did, and without the benefit of a calculator, it seems to me as if the dollars per month per unit are more or less the same as they were in his project.

I calculate in the range of $180, maybe $200.

How much was the rent of the project outlined in No. 4 reduced from that rent which would have been paid but for the income tax credit, by the presence of the tax credit?

Mr. Terner said, in his project, the beneficiaries got $185 out of $200 in benefit.

What percentage of benefit did the people who live in project four get?

Mr. **Ols**. None.

Mr. **Greer**. That's correct, Senator. Zero.

Senator **Graham**. So you're saying that the benefit to the American taxpayer and to this low income family in project four of giving approximately $180 plus per month of tax credits to the developer was zero?

Mr. **Ols**. That's right. I was trying to go and say how much more could we get. I was taking the tax credit back; I misunderstood you.

Mr. **Greer**. Senator Graham, I'd just like to point out one thing. This $2 million figure here is the proceeds that the developer made. The actual tax credits were twice that much.

Senator **Graham**. More than twice that. I tried to do that calculation to be parallel with the calculation I understood Mr. Terner was doing. Going back to the full value as opposed to the proceed valued through the 10-year, 12-month division. That's how I arrived at the number of roughly $100 per month per unit.

Mr. **Ols**. In our statement on that project four, the one we have there, it shows the actual tax credit in the footnote, it's $5,132,000 is the total tax credit.

Senator **Graham**. From a jurisdictional standpoint, the low income tax credit program is under the jurisdiction of the Finance Committee. There is legislation to reauthorize the low income tax credit pending before that committee.

I would be interested if subsequent to this hearing you could review that legislation in light of the experience that you have just had in analyzing these instances and give us any recommendations which we might forward to the Finance Committee for its consideration when it takes up this legislation.

Mr. **Ols**. We would be glad to.

Senator **Graham**. I have two final questions.

One, in some hearings before the House, there have been allegations that there were certain encouragements given to developers to contribute to an organization known as Food For Africa.

Is there any pattern that you have discerned, if you're familiar with that organization, of contributions being made by developers who secured a waiver from the Assistant Secretary in order to have a higher rent allowance?

Mr. **Adams**. We found no correlation on that, although we didn't focus on this specific point.

Senator **Graham**. Do you have the information as to which developers have contributed to the Food For Africa project?

Mr. **Adams**. We do have that, sir.

Senator **Graham**. So you could do the correlation as to those developers which received a rent waiver and those who contributed to the fund?

Mr. **Adams**. Yes, we could.

Senator **Graham**. I would appreciate it if you would do that analysis.

Mr. **Adams**. We'll submit it for the record, Mr. Chairman.

[The information referred to follows:]

In response to a request to provide a listing of individuals who contributed to F.O.O.D. for Africa and also benefited from waivers from certain coinsured processing requirements, we expect to be able to provide the data by September 8, 1989.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-4500

OFFICE OF THE INSPECTOR GENERAL

October 20, 1989

Mr. Edward M. Malan
Editor
Senate Committee on Banking, Housing
  and Urban Affairs
Room SD-534, Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Malan:

This is in further response to your request of August 4, 1989 concerning the transcript of the August 2, 1989 hearing before the Senate Committee on Banking and Urban Affairs regarding HUD's Section 8 Moderate Rehabilitation Program (MRP).

On August 18, 1989, we provided interim responses to questions by Senator Graham for pages 125 and 138. The Office of Housing recently provided us with copies of all waivers granted for MRP projects that were coinsured by HUD. We then prepared the enclosed schedule showing the project owners and the dates of any contributions the owners made to F.O.O.D. for Africa. This schedule should provide the information that Senator Graham requested.

Should you or your staff have any questions, please call me or John J. Connors, Deputy Inspector General, on 755-6430.

Sincerely,

Paul A. Adams
Inspector General

Enclosures

TYPE WAIVER	PROJECT NAME	PROJECT NO.	DATE REQUEST	DATE APPROVAL	APPROVING OFFICIAL	DEVELOPER PRINCIPAL	CONTRIB. AMOUNT	CONTRIBUTION DATE	TYPE WAIVER
RENT	COLONY APTS COLUMBIA,SC	054-36606	UNKNOWN	07/02/87	DEMERY	TRENT,WALTERS F. & DEWARD K.			RENT- WAIVER IN MARKET COMPARABILITY IN IN ESTABLISHING CONTRACT RENTS. HIGH COST-WAIVER OF HIGH COST LIMIT PROVIDED IN REGULATIONS. 97% OCC- WAIVER OF REGULATORY 95% OCCUPANCY LIMITATION IN PROCESSING APPLICATION. 2ND MTG- REQUEST FOR APPROVAL OF 2ND LIEN.
RENT	FOUR SEASONS GASTONIA,NC	053-10523	[illegible]	11/20/87	DEMERY	BAGGETT,SHADRICK			
RENT	CLEVELAND GARDENS LAS VEGAS,NV	125-36697PM	11/12/87	12/09/87	DEMERY	SCOTT,D.R. & JAMES & RANDALL & LAWRENCE			
RENT	KIMBLEY APTS [illegible],MD	052-36611	UNKNOWN	06/23/87	DEMERY	SIEGEL,WILDER,RICHMAN			
RENT	LAKEVIEW HEIGHTS CLEARFIELD,UT	105-10504-REF	09/17/87	11/02/87	DEMERY	QUEENAN,COOKE	QUEENAN $1,000.00 QUEENAN $35,000.00	10/06/87 04/28/88	
RENT	RENO APTS RENO,NV	125-10500	UNKNOWN	09/25/87	DEMERY	QUEENAN,JOHNSON,NIELSEN	JOHNSON $1,000.00 NIELSEN $1,000.00	04/15/88 04/15/88	
RENT	WINDSOR CT APTS AURORA,CO	101-36615PM	[illegible]	10/21/87	DEMERY	ABRAMS,WINN,WILSON,QUEENAN	WILSON $2,000.00 ABRAMS $1,000.00 WINN $1,000.00 WILSON $1,000.00	04/22/88 04/05/88 04/08/88 07/22/87	
HIGH COST	WEST DADE LTD II MIAMI,FL	066-10531REF	06/20/88	07/25/88	HAMERNICK	MARTINEZ,BARRERO			
97% OCC.	CORONADO CTS DOUGLAS,AZ	123-36605	10/08/86	UNKNOWN		BRAASCH,KENT B.,& DANA,IRVING			
97% OCC.	WEST DADE LTDII MIAMI,FL	066-10531	03/22/88	04/05/88	HAMERNICK	MARTINEZ,BARRERO			
97% OCC.	SUN GARDEN/NORTHINGTON TULSA,OK	118-36605	05/12/87	06/05/87	DEMERY	CARNES,BARRETT			
97% OCC.	RENO & LINDEN APTS RENO,NV	125-10511 125-10500	06/16/87	07/09/87	CUSHING	QUEENAN, JOHNSON, NIELSEN			
97% OCC.	CHAPARRAL APTS MIDLAND,TX	133-36606	11/04/88	12/27/88	CUSHING	CARNES,BARRETTO			
97% OCC.	DELMAR APTS GILLETTE,WY	109-10502	06/19/87	07/09/87	CUSHING	QUEENAN,HANSON,MEIDE	HANSON $1,000.00 MEIDE $10,000.00 HANSON $1,000.00	10/06/87 04/26/88 04/25/88	
97% OCC.	LAKEVIEW APTS CLEARFIELD,UT	105-10504	05/18/87	07/08/87	DEMERY	COOKE,QUEENAN			
97% OCC.	PEBBLE CREEK APTS ARLINGTON,TX	113-36607	09/29/87	11/05/87	DEMERY	MUSS,CARMEN			
97% OCC.	EL JARDIN APTS DAVIE,FL	066-10539	11/17/88	01/19/89	CUSHING	SHEIV,RUBY & LEWIS			
97% OCC.	GROVE PARK APTS GARDEN GROVE,CA	143-36611	[illegible]	[illegible]	HAMERNICK	WEINSTOCK,DELL			
97% OCC.	ATLANTA TERR WASHINGTON,DC	000-36636	07/01/88	07/19/88	HAMERNICK	WINN,COLE,KERRY			
2ND MORTGAGE	GREENLEAF APTS [illegible]	084-36613	12/01/88	02/08/89	HAMERNICK	LEVITT			SEE ABOVE DONATIONS.

Senator GRAHAM. A final question that I have is where do we go from here?

Obviously, we've got some important legislative architectural work to do to bring this program and its management into acceptable form.

I'm also interested in what we might do with currently existing contractual relationships which were entered into based on what might be fraudulent and collusive relationships.

What are in your opinion the opportunities that we might recapture at least some of the excess rentals that have not yet been paid?

We have a 15-year contract to pay rents that are as much as 40 percent possibly over what they should have been.

What are our opportunities to reopen those contracts and readjust the rents to more appropriate levels?

POSSIBLE ADJUSTMENTS TO CONTRACTS

Mr. ADAMS. That's part of the specific recommendations flowing from our audit, Mr. Graham. The Secretary has directed that his Assistant Secretary for Housing undertake such a review to determine if it is feasible to do those, and that that be done in two steps.

One is the one that we've specifically looked at. And then the second step would be take a look at all other projects.

Senator GRAHAM. What is the timeframe for that review?

Mr. ADAMS. I don't recall. Maybe Mr. Greer does.

Mr. GREER. They're coming to us with a timeframe probably by the end of August. We expect that will take some time to do the 300 or some odd projects that need to be reviewed.

Senator GRAHAM. Could you not focus then on those that appear on your analysis to be the most egregious, where there's the greatest degree of larceny to the public involved?

Mr. GREER. Program staff has already attempted to prioritize for us which ones they will look at first. Those things that you're mentioning are tops on that list.

Senator GRAHAM. Every month that those rents are paid is another month that the public is ripped off and that funds that could otherwise be used to benefit low-income American families are denied.

Mr. GREER. That's correct.

Senator GRAHAM. Does anyone have any concluding comments for what has been an extremely instructive, analytical hearing—extremely instructive and analytical hearing—and one for which we are deeply indebted to each of you for your generous and significant contributions.

Yes, Ms. Truett?

Ms. TRUETT. Speaking about recapturing excessive rents, et cetera, perhaps what we might do is redirect those rents to the services I mentioned earlier. We do that sometimes to convicted felons. We make them do community service.

Perhaps we could take those rents and set up a very quick program of child care, employment training, all of the things that people need that have a low income to be able to become mainstream society people again and not have to depend on a rent stipend.

Senator **Graham**. Yes.

Mr. **Schussheim**. Mr. Chairman, I would like to add one thing. I think it's important that we should try to start rebuilding capability of the Department of Housing and Urban Development.

Their personnel have been cut since 1981 from almost 16,000 to a proposed 12,200 in the fiscal year 1990 budget. They simply don't have the staff as far as I can tell to do the kinds of technical work that need to be done to oversee these programs in an efficient, effective manner.

We also need better data. We've mentioned using annual housing surveys to update some of the work that was done to establish the fair market rents.

Today, they're doing this for only 11 metropolitan areas on a 4-year cycle, a total of 44. Well, when this was started in 1973, there were 60 areas that were being surveyed on a 3-year cycle.

We ought to think about reestablishing the old market analysis division within FHA, which put out market studies for individual market areas.

That probably had some effect in preventing overbuilding in areas like Denver or Fort Worth or Oklahoma City. So there's much to be done, I think, to reestablish the capabilities of HUD as well as its morale.

Senator **Graham**. Any other comments?

Mr. **Adams**. I would like to agree with Dr. Schussheim. The Department does need to rebuild its capacity. We've experienced a substantial brain drain in the past few years, indeed, several years, and I think it's not only true of HUD but Government employment as a whole. Government employees have been demoralized, beat upon and don't find it a very rewarding experience any more.

And I say that as a career civil servant. I just hope that better things are ahead for us in that process.

Senator **Graham**. Mr. Adams, I concur in your observation on the importance of a dedicated civil servant corps which has a clear understanding of its broad public responsibility.

And I'm very pleased those of you who have been with us today epitomize that spirit of public service.

Mr. **Adams**. Thank you.

Senator **Graham**. Thank you very much.

If there's no further business, the meeting is adjourned.

[Whereupon, at 1:10 p.m., the committee adjourned.]

ABUSES IN THE SECTION 8 MODERATE REHABILITATION PROGRAM

MONDAY, SEPTEMBER 18, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Graham, Bryan, Shelby, and Dixon.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order. Let me welcome all those in attendance. Today, we are continuing our work in building the foundation of information needed to fully understand the nature of the abuses that took place in the Department of Housing and Urban Development, the Mod Rehab Program and other programs in recent years.

Today's hearing will start a series of three hearings which will be held over the next 2 weeks that will focus on the HUD Mod Rehab Program. And what we will be doing is exploring how simple program elements work in combination with each other.

We will be exploring how fair market rents, how car insurance and how the low-income tax credit also worked together in combination with the Mod Rehab Program to create the abuses that we have seen.

These hearings build on the work of hearings begun in May and August. HUD's Secretary Kemp has estimated that at least $2 billion was lost at HUD through mismanagement and program abuse.

Throughout the course of these hearings, we will be trying to determine exactly what went wrong and what can be changed to avoid the statutory and regulatory missteps which created this massive program abuse.

The lessons learned from the course of this investigation will provide the basis for actual legislative work that will restructure and, hopefully, eliminate the potential for fraud by persons both inside and outside of the Government.

The most important objective to keep in mind is that the program should serve those persons whom they were intended to serve. And during this time of rapidly rising housing costs, increasing numbers of homeless persons on the streets and tight budgetary constraints, it is obviously imperative that HUD funds go only to persons who need housing and who have been listed as persons requiring Federal assistance in that regard.

I just want to say one other thing before turning this hearing today over to my colleague, Senator Graham.

This committee worked nonstop for several months on the S&L legislative package. We did so because of the urgency of that problem and the direct request of the President of the United States that we put other things aside in order to get that legislation enacted and in place.

Those work requirements were met. That job is now done. And so we now in the committee move on to a variety of other important issues, and we have a very ambitious work schedule laid out down through the remainder of this legislative year that covers a number of topics.

Early on, during the S&L effort, we did some hearings here, important hearings, where we had witnesses that gave us some very troubling testimony. What we have done in the time since, and with the very important leadership of Senator Graham of Florida, who has shown a great interest in this topic and has devoted countless hours to building the facts into a coherent whole, is that we are now proceeding under the authorization of a committee vote to investigate these problems, Mod Rehab and other program abuses.

And we are proceeding in a fashion by understanding precisely the anatomy of how these programs work. How is it that they were ripe for abuse?

And one of the early findings is that you can't look at these programs in a one-dimensional way. You have to look at them as they work in combination with other aspects of Federal law.

So that the items that I have mentioned here earlier with respect to coinsurance and fair market rents and other elements that go into the puzzle really in combination are what create the potential for the scale of abuse that we have seen.

So we will continue to lay this out in detail so that we understand precisely how these programs were structured. And when we have completed that phase, as we will in large part with the three hearings that are scheduled here, we will then move from that into other major areas of this problem.

In due course, we would expect to have before this committee every major figure that has been involved in this problem, including HUD Secretary Pierce, his chief aides in the Department of Housing and Urban Development, and others, including those who were able to derive enormous personal benefit from these programs, way beyond anything that was intended or to this Senator appears proper.

So the foundation that we are putting in place now is crucial I think to let us decide precisely what the legislative changes are that's needed in the format of these programs as we go into the future here.

Having said that, I want to yield the chair here to my colleague, Senator Graham, and I'm going to move over so that he can come and take this position, and ask him if he will introduce the witnesses today and conduct this hearing.

And I and others will be here and will take part under his direction today.

Senator Graham.

OPENING STATEMENT OF SENATOR GRAHAM

Senator **Graham**. Thank you, Mr. Chairman.

I don't wish to be redundant to the statement that you have just made, which puts in context what we are going to be doing today and over the next 2 weeks.

As you indicated, this hearing is the first of a series of three that will attempt to examine the structure and weaknesses of the Moderate Rehabilitation Program as it has been implemented at HUD.

This series builds upon previous hearings which have shown that moderate rehabilitation subsidies were layered with other government enhancements, State and Federal, that enriched a few at the expense of the poor, who were designed to be the beneficiaries of this program.

Last night, we said that we had discovered the rats. Now we want to look at the cheese that attracted those rats. The three main attractions were high rents, coinsurance and low-income housing tax credits.

Today, we will begin to explore the moderate rehabilitation rent structure. This structure has been referred to in the statutes, the regulations, and will be referred to in testimony today as fair market rents.

Testimony from our August 2 hearing indicated that some moderate rehabilitation rents were anything but fair. Fair market rents were based on old data which could not reflect local market conditions.

Second, rent calculations did not take into account change in market conditions, such as soft real estate markets. Therefore, developers were able to charge rents that exceeded the true market value of moderate rehabilitation units.

Third, it appears that HUD granted waivers for reasons not covered in the section 8 statute which allowed developers to disregard fair market rents altogether.

This morning, we will expand on what we learned last month about the structure of the moderate rehabilitation program that made it a target for abuse, and we will focus on how fair market rents contributed to that abuse.

Mr. Chairman, I thank you today for your great leadership in this committee in sponsoring this major investigation and I am certain that your knowledge and insight will add greatly to our better understanding and ability to recommend to the Congress appropriate remedies.

Our first panel today is a one-person panel, made such by the unfortunate injury over this weekend to Ms. Amy Jones, the Project Manager of ICF, Inc., Fairfax, VA.

Ms. Jones was to have participated but, unfortunately, broke her leg and is unable to appear. She will be invited to participate in a future hearing of this committee.

Mr. Melvin Adams.

STATEMENT OF MELVIN ADAMS, ASSISTANT EXECUTIVE DIRECTOR/DIRECTOR OF DEVELOPMENT OF THE HOUSING OPPORTUNITIES COMMISSION OF MONTGOMERY COUNTY, KENSINGTON, MD

Senator **Graham**. Mr. Adams was the former Director of Housing Programs for Dade County, FL. He is now Assistant Executive Director and Director of Development for Housing Opportunities Commission of Montgomery County, Kensington, MD.

Mr. **Adams**. Thank you. Senator, it is a pleasure to be here. Your coming to Washington improved the quality of the representation in the Senate but, unfortunately, it resulted in a lesser quality in the State house.

Senator **Graham**. I appreciate that second statement. There was a famous observation in Florida politics made by a Georgian:

Why were so many Floridians moving to Georgia, to which Governor Talmadge responded:

"Every time a Georgian moves to Florida, it raises the IQ level of both States."

I appreciate the fact that you only commented on one positive change. Thank you.

Mr. **Adams**. I am really here to testify as an individual, not representing any organization. I did work for Dade County as director of their housing agency from 1971 until 1986. I would like to introduce into the record a copy of my testimony dated September 18.

You may have the May 15 testimony that I never delivered, so I would like to slightly update it. But it is essentially the same.

I have been a public servant all my life. I believe as a public servant you have to be able to justify what you do. You should feel comfortable if it is in the headlines, in the Washington Post, and you have an obligation to come and explain or discuss with any legislative body or others what you have done. That is public service.

The concept behind the section 8 moderate rehabilitation program is very sound. The program has gotten some bad raps, but I think it is because of the way it was administered. The program helped—can help to provide and has desperately needed housing.

It can rehabilitate bad properties and it can help to revitalize neighbors. In Dade County, Moderate Rehabilitation often involved as much rehabilitation as the old section 8 substantial rehabilitation program.

But the rents were much lower. Some of the property proposed and carried out for Mod Rehab in Dade County were an Overtown Liberty City and Little Havana.

FAIR SHARE FORMULA

The problems with the Mod Rehab program did not exist when there was a fair share formula. There was no influence in Washington. Each locality got an allocation of units and advertised and evaluated the proposals and selected those that best met its objectives.

However—and that is the way we did it in Dade County.

When fair share ended, and it ended as a result, as I read some of the testimony, it seems to have ended because Congress changed it. But the administration recommended, strongly recommended, that fair share be eliminated and Congress agreed with that recommendation.

Then it was a matter of decisions being made in Washington. A developer—and I cannot remember his name, but a developer came to me and said that if there was some assurance that one of his projects could be funded, he thought that he could get us some moderate rehabilitation funds.

At that time, there was a terrible housing shortage, as you know, in Dade County. We were inundated with refugees. The vacancy rate was virtually nonexistent in affordable housing. And I felt it was appropriate to do anything we could that could be publicly supported to obtain some units of housing.

So we changed our administrative plan. We publicly advertised that we did not have any section 8 units, but we were going to develop a waiting list so that when we got section 8 units we could move quickly.

We also said in the plan that, when we did get an allocation, we would go down the waiting list so that we could use up the entire allocation, if possible, without going out for new projects.

We sent this plan to HUD. We never heard from HUD, but HUD was aware of the plan. We then would get allocations, and it was very clear—and your testimony in the past has shown that the HUD allocations were really project-specific. When we get an allocation for 73 units, 50 efficiencies, 23 one-bedrooms, there was only one project in the list that met that and HUD knew how we were going to select.

They, in effect, were giving us an allocation for that project. The consultants that represented the developers had no contacts with us. Their contacts were solely in Washington. In retrospect, I think it was somewhat strange that the developers had—well, it wasn't strange. But, these were section 8 Mod Rehab funds that went to local government, obviously. They were working for the developer.

When I was in Dade County up until the mideighties, when we wanted some Federal assistance, we used our staff and the county had a legislative liaison body that would help us lobby the Federal Government. And we had a paid lobbyist in Washington.

As you know, Senator, the State had an office in Washington that helped local government and States get funds. So these developers who hired consultants, the consultants were not working for local government, obviously. They were working for the developer.

The yellow light is on, but I think I'm done with my testimony. Anyway, I will be happy to elaborate on or answer any questions you have. I have some thoughts as to how the program might be administered.

[The complete prepared statement of Melvin J. Adams follows:]

TESTIMONY OF
MELVIN J. ADAMS
BEFORE
THE SENATE COMMITTEE ON
BANKING, HOUSING & URBAN AFFAIRS

September 18, 1989

My name is Melvin J. Adams. Since November 1986, I have been Assistant Executive Director of the Housing Opportunities Commission of Montgomery County, Maryland. From 1971 until 1986, I was Director of the Department of Housing and Urban Development of Dade County, Florida. The Department was responsible for public housing, urban renewal, relocation, housing code enforcement, locally financed housing program, and Section 8, including moderate rehabilitation. From 1985 until 1987 I was President of the National Association of Housing and Redevelopment Officials. Since 1952, I have worked in housing and redevelopment at the federal, state and local levels.

I appear before you today as an individual, not as a representative of any organization.

The concept behind the Section 8 Moderate Rehabilitation Program is sound. Not only does the program provide desperately needed, affordable housing for low income families, but it plays an important role in rehabilitating deteriorating properties and revitalizing neighborhoods. In Dade County, many of the moderate rehabilitation properties involved as *much rehabilitation as the discontinued Section 8 substantial rehabilitation program, but at significantly lower rent. Some of the property proposed for mod rehab were in Overtown, Liberty City and Little Havana.*

Before outlining how the moderate rehabilitation program worked in Dade County, I would like to give you some background of the conditions in Dade. We had a critical housing shortage, with one of the lowest vacancy rates in America. This was caused to a large extent by the tremendous influx of refugees. This housing crises and the deterioration of inner city neighborhoods were among the causes of urban unrest in Miami and Dade County. In spite of the recognized need for new and modernized public housing, the Feds reduced our funds for public housing to a trickle.

While HUD had nailed shut the public housing window of opportunity, it had opened wide the Section 8 moderate rehabilitation window of opportunity. After the fair share formula ended, a developer told me that he could obtain mod rehab funds for Dade County if there was a way of assuring that his project would be funded.

In response to this, we revised our administrative plan and sent it to HUD for approval. Under the plan, as each proposed project was submitted to Dade County, it was placed on the waiting list and sent to HUD with a request that it be funded. When Dade received an allocation under the plan, the first project or projects on the list that would use the entire allocation would be selected. The fact that each HUD moderate rehabilitation allocation fit a project on the waiting list as to number of units and bedroom distribution meant that for all practical purposes HUD made project specific allocations. The plan and the waiting list were public documents; the Dade County development community, and HUD were aware of both.

I will be happy to answer any questions or elaborate on any of the points in this testimony.

Senator **Graham**. Thank you very much, Mr. Adams. And I would like to take up your last comment of soliciting some suggestions for remedies. Before I commence questioning, however, we have been joined by Senator Bryan.

Senator Bryan, do you have an opening statement?

Senator **Bryan**. Thank you very much, Mr. Chairman. I'm going to yield my time back and ask Mr. Adams questions when my time comes. Thank you.

Senator **Graham**. Senator Dixon has submitted a statement which will be included in the record.

STATEMENT BY SENATOR ALAN J. DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to see that you have called for a second in a series of committee hearings to investigate the various HUD programs and the many alleged improper activities surrounding them.

I understand that the focus of the committee today will be on fair market rents. According to the HUD inspector general, the basic problem that he and his staff noted is that rents were established at artificially high levels in relation to the actual rent levels in the project locations.

From these hearings, I hope that this committee will be able to determine what went wrong, how it happened, and offer remedies for making corrections in the various HUD programs.

Our depleting Federal funds that are allocated for HUD programs are intended to aid low- and moderate-income families and not to be swindled by those who prey on the less fortunate. For one, I am here to oversee that our mission is accomplished.

Thank you, Mr. Chairman.

Senator **Graham**. Mr. Adams, it was indicated in my opening statement I'm particularly interested in the issue of how fair market rents were calculated.

Could you review for us how fair market rents were calculated under this program? How were they, if they in fact were substantially different from calculations under other section 8 programs, and was there any change in the procedure for the calculation of fair market rents over the 7 or 8 years that you were involved in administration of section 8 Moderate Rehabilitation Programs?

CALCULATION OF FAIR MARKET RENTS

Mr. **Adams**. Well, when we got an allocation, I didn't personally review the numbers, but the staff did. So I am not saying that I didn't—the fact that I didn't personally do it, it was still under my watch.

We would look at the cost, the cost of rehabilitation. We would determine whether it was necessary, whether the estimated costs were reasonable. We would look at the soft costs involved compared to HUD's requirement that—I think there was a 2-percent or 3-percent limit on soft costs.

We would look at the acquisition price and we would determine what we thought the fair rents were at that time; since all but one of our projects involved more than 50 units, we had to submit all of these numbers to HUD and HUD had to go over it and approve it.

Someone mentioned earlier about tax credit. The tax credit program did not exist when I was in Miami. But I still can comment on it because in my present job we have done some tax credit projects, very well, I think.

Senator **Graham**. If you could comment, since the tax credit has been part of the overall package of benefits available for low and moderate income housing, how has that been taken into account in the judgment of what constitutes fair market rent?

Mr. **Adams**. I suspect, and again, the tax credit experience I had has not been with section 8, but I suspect it has been ignored. I think that the tax credit was another benefit that a developer could get and that was over and above the fair market rent.

The legislation that is talking about extending the tax credit, eliminating the sunset, requires government now to make sure that the tax credit, in effect, helps projects and is not put in the hands of the person that syndicates it.

And there's only as much tax credit given to a project as is necessary to make it feasible. And I am sure that none of that happened under the section 8 Mod Rehab.

Senator **Graham**. The statute under section 8 is quite general in terms of fair market rent. It uses essentially that term and leaves to regulation and practice most of the detail of how it will be carried out.

In our hearing in August, we had testimony from a non-section 8 but a nonprofit developer in California as to how his organization went about establishing fair market rents. And he indicated that their process was to do an evaluation of what rents similar units were deriving in the neighborhoods in which his concern was considering doing business.

And in response to a question, he indicated that was a fairly simple and common method of determining fair market rents. Why doesn't HUD in its regulations under section 8 utilize a similar approach rather than what I would define as the public utility cost-based approach which you indicated, in fact, is being used?

Mr. **Adams**. I think that would be a valid way of doing it. You need to leave some area for exception. That should be the exception, not the rule if there are circumstances that would justify a high rent.

But that could be—the general basis of that could be spelled out in legislation or regulation.

Senator **Graham**. I wonder if that, in fact, hasn't already occurred. The current statute, which is the 1978 Moderate Rehabilitation Program amendment to the 1937 Housing Act states:

> The Secretary may in tearing out the provisions of this act establish a maximum monthly rent for units upgraded pursuant to this paragraph which exceeds the fair market rental by not more than 20 percent. If such units are located in an area where the Secretary finds cost levels so require.

But that appears to build upon fair market rent and then allows a 20-percent additive. And, later on, it even allows up to a 30-percent in unusual circumstances.

But the basic question of how you arrive at the fair market rent upon which those additives will then be layered is left to regulation and regulation appears to utilize a utility approach to arriving at fair market rent.

That is in regulation 882.102 of the Department, is the definition of how fair market rents will be established. And they utilized the system as you have described it.

Mr. **Adams**. I think then my answer would be that HUD didn't administer the program in accordance with those criteria. And, of course, I think Dade County was a high-cost area. Real estate was high. Most of our projects exceeded fair market rents and got Federal approval.

But it still probably could have been done a little tighter.

Senator **Graham**. From your testimony in previous testimony, it appears as if the date when the program moved from fair share to discretionary was a watershed in the administration of this program. Did you observe any differences in the number of projects that were receiving the full 20 percent or the special beyond 20 percent, not to exceed 30 percent, allowances of fair market rentals? That was a function of whether they were before or after the elimination of fair share.

Mr. **Adams**. I don't have the records here and I just don't remember. I know that the negotiations were a lot different after fair share ended because——

Senator **Graham**. The negotiation on the rents?

Mr. **Adams**. On the rents and the processing at HUD.

Senator **Graham**. Could you describe what were some of the differences in negotiation on rents after fair share was eliminated?

Mr. **Adams**. It was my impression that there was more direction from Washington when—if the area office could not approve fair market rents in excess of maybe—I don't know if it was 110 percent. There was some percent that they couldn't go above, so they would submit it to the regional office and it invariably came back approved, what the developer had requested.

Senator **Graham**. One of the reasons why this issue has become of special interest is because the question of how in projects that are designed to be occupied by low and moderate income persons was there enough profit margin to support the very large expediter fees that we understand were being paid.

Testimony that we have had previously indicates that those fees averaged approximately $1,000 a unit. Where in the system was there a sufficient surplus in order to absorb that kind of cost?

The **Chairman**. Mr. Chairman, if I may interrupt, there is one procedural item we did not attend to at the beginning, and that is really my error in terms of not recalling to do it. And that is we need to swear the witness, as we will all witnesses. We have been swearing them all the way through, and I don't want to create an awkward situation where we do one and not another because that is our standard practice. And we have done that with all of the rest.

So let me ask you to stand, if you will.

Do you swear that the testimony you are about to give is the whole truth, nothing but the truth so help you God.

Mr. **Adams**. Yes, including all the testimony I have given, yes.

The **Chairman**. Thank you.

Senator **Graham**. Retroactive verification of his testimony.

[Witness sworn.]

Mr. **Adams**. I've lost your question.

Senator **Graham**. The question is, after the fair share program was eliminated, a number of changes occurred in the program. One of those apparently was the increased use of private consultants to serve as expediters of projects within HUD.

We have received testimony that those consultants received fees which ranged but tended to cost around $1,000 a unit. So, an applicant for 100 units would normally have been expected to have paid $100,000 to an expediter to get it through the process here in Washington.

How did the projects have enough fat in order to absorb a $1,000 a unit expediter fee?

EXPEDITER FEES

Mr. **Adams**. I can answer in general. I would have to look at a particular project, but most of the developers we had were also builders, or part of the team was the builders. So there was a builder's profit. Most of them managed the properties, so they got revenues managing.

Some of them owned the property to begin with and just needed the section 8 rents in order to stabilize the property.

Some of the developers did tax-exempt financing and put together a team and they probably got something out of that.

And, finally, when the tax credit came into affect, they could sell the tax credits and just take that money. And that was free money to them because I strongly doubt that anyone looked at tax credit revenues as a way to help, I would say, legitimately finance the project.

Senator **Graham**. So, a combination of a utility-based method of arriving at the rents and then layering States and Federal benefits, which did not result in any reduction in either the subsidy to the Federal Government or the rents to the occupant created the fact that—or to use our analogy—the cheese that allowed the rats to cluster.

Mr. **Adams**. Yes.

Senator **Graham**. Or nibble or bite.

Mr. **Adams**. Bite

Senator **Graham**. Mr. Chairman?

The **Chairman**. Let me ask you, I can understand if a builder is involved or someone like that, that there is a certain kind of transactional involvement in margins that would be built in there, large or small. But what about somebody like a James Watt?

You are familiar with the story about how he called and apparently was successful in persuading people at the top of HUD to assign Mod Rehab units to certain specified projects and then he took a very large fee as a result of that.

When somebody appears to be totally at arm's length, quite different than the description you just gave, what is the basis for somebody like that cashing in to that extent?

How is that justified?

Mr. **Adams**. In my book, it is not justified. I think that developer would feel that what he had to pay, that James Watt was worth it to him or her in order to get the project approved.

The **Chairman**. Isn't that another way of saying:

If you don't pay James Watt to intervene, presumably, you don't get the project approved?

Mr. **Adams**. I think that was very clear because we had projects on our waiting list in Dade County for—one of them was on from the beginning. It never did get approved.

Another one was on for a couple of years without a representative consultant. And then the developer just got tired of being bypassed, hired a consultant and it got approved.

The CHAIRMAN. When were you aware of the fact that there was this kind of system going on? Or the appearance of this kind of a system going on?

Mr. ADAMS. I think as soon as the fair share ended and we were told by developers that they could get units if there was some guarantee—if they knew whether or not their project would be approved. I knew there was something going on, I didn't know the nature of it.

And then I heard maybe in 1985 that you hired people and if you paid them $1,000 a unit, then you would get your project approved.

None of these people ever—I never saw any. They never lobbied me because I couldn't deliver anything.

The CHAIRMAN. Let me ask you this.

The statistics we have indicate that the Dade County Housing Authority received a disproportionate share of the Mod Rehab allocations between the fiscal years of 1984 to 1988. And during this period, Dade County received four times as many Mod Rehab units as the District of Columbia, the State of Massachusetts and the city of Chicago, and 17 times as many units as the city of Philadelphia.

What were the factors that would account for such a phenomenal success rate for just one location?

Mr. ADAMS. Well, let me give you two levels of factors.

One, we had a real housing crisis, refugees, very crowded housing.

Two, HUD was always concerned that if you got Mod Rehab units, you had to use them. They didn't want them hanging around for a couple of years. We were able to deliver the units and get them into occupancy.

And I think we had the staff that had the competency to review the applications.

So that is one level of reason.

I think the other level of reason is the purpose of these hearings. They were politically connected. They hired politically connected consultants. And the awards after fair share were very clearly project-directed.

We heard from developers——

The CHAIRMAN. Project-directed means based on politics?

Mr. ADAMS. Yes.

The CHAIRMAN. Is that what you mean?

Mr. ADAMS. Yes. We needed the units. We used the units. As a local housing official, it did not bother me to get more than my fair share.

Let me clearly—and I realized we were getting far more than our fair share.

The CHAIRMAN. Now, a separate inspector general audit indicates that eight landlords received 95 percent of all of the units awarded in Dade County, since October 1, 1984.

The audit also concluded that the housing authority, and I quote now, the audit report, quote, "Did not competitively select projects during his period."

Do those facts square with what you know to be the case?

Mr. **Adams**. The majority. I think both of them are true. As I said, however, in my testimony, we sent HUD our revised administrative plan which indicated that we would not competitively bid once we got an allocation. And HUD allocated time and again the units recognizing that we had changed our administrative plan.

The **Chairman**. Why did you change it? Why wouldn't you continue to sort out the projects that you, yourself, thought were the best ones to have?

Mr. **Adams**. Because based on what funding we got from HUD for other—that Dade County got for other low income housing programs, we would have gotten few, if any, units.

The **Chairman**. So are you saying that, in effect, that what happened was you figured out that if you took off your list projects that you might want more and sent them in, you would not get those approved; whereas, if you took a different list that was obviously aimed at the projects that HUD and Washington wanted, that they would approve that list?

Is that right?

Mr. **Adams**. Yes. HUD knew what our list was. Every time that we got a project in, we added it to our list. We sent it to HUD. They knew how we were going to select.

The **Chairman**. Mr Adams, I understand that you saw this as the only way to be able to work with HUD-Washington at that time, but doesn't that also mean that there would have been other projects in Dade County as deserving, some more deserving, that you couldn't get funded because they didn't get approved that way?

Mr. **Adams**. Yes. And I would have preferred the other way where we could set our priorities and get funded.

The **Chairman**. Give us a sense as to some of the ones that you might have wanted to do and should have done in a straight competitive process that got left out.

Mr. **Adams**. I cannot identify the ones, but——

The **Chairman**. Can you give a general description of what you are talking about?

Mr. **Adams**. Well, we might have wanted projects that helped to revitalize the inner-city neighborhoods. We might have wanted to negotiate lower rents. We might have wated to negotiate it longer-term, low-income.

I think, if I were ever doing another Mod Rehab project anywhere, I would want to make sure that when the 15-year period expired, that the low-income families living in that project would not be evicted, would not have their rents raised.

So there are lots of—and I would have wanted more family projects. The bulk of these were for elderly or for very small families.

FAVORED PROJECTS

The **Chairman**. Well, when the system got twisted around so that these favored projects were approved in Washington, doesn't that mean that people that would have gone into other projects that were then not funded got cheated out of these things? Doesn't it mean that in some of those inner-city locations and some of those senior areas, that people that might have gotten housing help didn't get it?

Weren't they cheated by this process?

Wouldn't they have a right to feel today as if they were cheated by it?

Mr. **ADAMS**. Yes. I think that process cheats local people because local government is best able to set what its priorities ought to be. And in this case, the Federal Government was setting them and not even based on any Federal priorities, but based on political influence.

The **CHAIRMAN**. This is a very important fact and it is very important testimony that you're giving because you are establishing the fact that people who are out there who needed the help and for which the help and the way the Federal programs were designed were not able to get the help, that the local housing authority would have allowed them to have, because Washington was diverting those decisions off to other people on the basis of politics.

Now isn't that what happened?

Mr. **ADAMS**. Yes, sir.

The **CHAIRMAN**. Well, that is a pretty sorry arrangement. I think we have tended to focus so far on the people that got rich in terms of wiring these decisions at the top. And I have said, and I will repeat in the future, the fact that I think people like Watts and others ought to give the money back. So far, there has been no indication that he intends to, but I think that would be the appropriate step to take. But there has not been enough focus on the people at the bottom who were cheated out of the very help that they were supposed to get.

And they in a sense are the nameless victims of this kind of fraud that are out there today, that you are very clear in your testimony to us that that is the way the system worked.

You didn't like it, but that is what is imposed upon you.

Is that your testimony?

Mr. **ADAMS**. Yes. I probably wouldn't say this if I were still in Dade County but I think it wasn't just people in Dade County who got cheated, but as you talked about other communities that didn't get anywhere near their fair share, those people got cheated.

The **CHAIRMAN**. Very well. I will reserve the remainder of my time.

Senator **GRAHAM**. Thank you, Mr. Chairman.

We have been joined by Senator Shelby.

Senator Shelby, do you have an opening statement?

Senator **SHELBY**. Thank you. I have an opening statement. I would like for it to be made part of the record.

Then, when I have my time. If it is not, then I have several questions.

[Statement of Senator Shelby follows:]

STATEMENT BY SENATOR RICHARD SHELBY

Senator **SHELBY**. Mr. Chairman, I want to commend you for scheduling this hearing and for giving us an opportunity to explore in greater depth the continuing allegations that the section 8 Moderate Rehabilitation Program has been mismanaged and consequently has cost the Government millions of dollars.

The Inspector General's report, testimony by witnesses before this committee and others, as well as press accounts, offer substantial evidence that the allegations are true. Frankly, I am disgusted. Congress recently finished legislation on what is referred to as the S&L "bailout" bill, which inevitably, will cost the taxpayers billions of dollars, largely because of fraud. The words "pentagon" and "scandal" have almost become synonymous over the years. And now we find that a hefty percentage of the few housing dollars that remain after 8 years of budget cuts have been wasted, used to line the pockets of consultants and developers. It is small wonder that the public's perception of the Federal Government is one of ineptitude and corruption.

It is important now that we resolve this issue. Secretary Kemp has taken a hands on approach and I believe that he has a good staff in place to assist him. It is the oversight responsibility of this committee to see that the systems and checks that are instituted by HUD are sufficient to prevent abuses in the future.

The absence of accountability was an important factor in this situation. It is my understanding that HUD regulations were often ignored with little apparent recourse. Public housing authorities failed to comply with HUD handbook regulations, and made significant errors in calculating the rents and number of eligible units. This indicates that there was neither adequate oversight from HUD nor severe enough penalties to deter public housing authorities from submitting incorrect applications. While a marginal amount of error is probably inevitable, the pervasiveness of the error indicates that the problem is systemic.

It is our obligation to the taxpayer to repair our housing programs. I get letters every day from constituents concerned over the homeless, over substandard housing, over unaffordable rents. I have to respond that we're doing the best we can with very limited resources in this time of budget deficits. Congress' credibility with the taxpayer is damaged by the revelations that the little money that is allocated is misspent because of fraud and favoritism. The taxpayers deserve more, much, much more for their money.

I support an overhaul of the Mod Rehab Program. Secretary Kemp has displayed concern over this matter and I have confidence that he will make every effort to correct it. We must ensure that there is adequate oversight and supervision of HUD programs. HUD must issue reasonable, effective regulations and public housing authorities and other applicants must follow these regulations. And we cannot tolerate even the appearance of influence peddling by former officials. If former officials are permitted to actively lobby current officials, maybe we should go back to the fair share allocation process.

I look forward to the testimony of the witnesses. Thank you, Mr. Chairman.

Senator **Graham**. Thank you very much.

Following the first arrived, first question rule, Senator Bryan.

Senator **Bryan**. Thank you very much, Mr. Chairman.

Mr. Adams, I am new to this panel. Tell me how fair share works. You have indicated that the watershed event as you see it is when this program was transferred from a fair share to a discretionary base.

How did fair share work?

FROM FAIR SHARE TO A DISCRETIONARY BASE

Mr. **Adams**. I don't know the exact nature of the formula, but every year, HUD would allocate X-number of section 8 moderate rehabilitation units to communities around the country. We would get those units by bedroom size and it was the result of what local need were as we determined them.

And then we would advertise. We would put an RFP out saying that we have these funds. Here are the criteria for our selection. Developers come in with proposals and we will evaluate them and make a selection.

That was fair share.

Senator **Bryan**. Was the fair share allocation based on population? A housing inventory shorage? How did HUD allocate what the fair share was, say, in Dade County versus another community in the country?

Mr. ADAMS. I think it was a combination. I am not that personally familiar with the factors. But it would be resulting in need population, housing shortage. But I don't know the exact elements.

Senator BRYAN. From your perspective at the lower level, was the fair share allocation system a good one?

Mr. ADAMS. Yes.

Senator BRYAN. it was fair not only from your perspective as a housing director in Dade County but fair in relation to its concept and its allocation generally for housing needs across the country.

Mr. ADAMS. The fair share, nobody ever got as much.

Senator BRYAN. I understand that.

Mr. ADAMS. But it was fair.

Senator BRYAN. At the conclusion of your prepared testimony, you indicated that you had some suggestions as to how we might correct or eliminate these abuses that you shared with respect to Senator Graham's questioning, and also Senator Riegle's questioning.

What ought we to do to prevent this travesty from occurring again?

Mr. ADAMS. I think there ought to be fair share and if a local government falls below a minimum level, that could go to a State and then the State could administer the program throughout the State.

Senator BRYAN. I take it, that would address the allocation of the units?

Mr. ADAMS. Yes.

Senator BRYAN. Clearly, the focus of this hearing this morning is the fair rental, the fair market rental. And there was widespread abuse, as you have indicated. I have been led to believe from testimony I have seen previously and from what has been reported to me that coinsurance, the coinsurers played an important role in fixing what that fair rental was. And then, indeed, in many instances, that far exceeded what might even be the market value in the community for that type of housing.

That is to say, they were not comparing apples to apples, that the rental values might be comparable to, say, luxury or upper income levels. Apartment rentals. But, when compared with comparable housing, that the rents were way out of line.

Could you share any insights with us on that?

Mr. ADAMS. I have a general knowledge of coinsurance and some of the scandals in that program that go beyond section 8 Mod Rehab.

The coinsurers would have no particular reason to squeeze the rents down. HUD might if they weren't coinsured and HUD had to look at it, but a coinsurer wouldn't.

But I don't have any personal knowledge.

Senator BRYAN. How should we structure the fair market rental calculation? In other words, if you were given the pen today and were to draft a regulation that protects the American taxpayer, that provides fairness and equity in terms of the program itself, in essence, what would that regulation say? How would you draft it?

Mr. **Adams**. Well, let me tell you what I might do.

Senator **Bryan**. OK.

Mr. **Adams**. Someone else can draft the regulation.

Senator **Bryan**. I'm using it only in a rhetorical question. I'm not asking you to scratch it out this morning, but what are the elements? What should be included in that?

Mr. **Adams**. I think we would want to look at the public purpose of the project we would set in any development we wanted to move ahead with. We need to analyze that, the numbers in that development, just like the developer would. And we would want to get maybe a longer low income period, maybe lower rents.

We would want to—the local government, if they are the ones administrating it, ought to look at the fair market rents as if it is really their money going into it, their personal money.

We do it in Montgomery County where I now work on all kinds of developments that come in that we finance. So we can do that.

And then you set the rents and they are justifiable based on the services. If you have competition so that a developer isn't wired prior to that competition would be what the rents are going to be.

It doesn't take any genius to do this kind of thing.

Senator **Bryan**. So you are saying that within the fair allocation that a local community would get, developers would compete for projects which met the criteria of the kind of housing that was needed, and that the local housing authority would make a determination amoung those developers and weight it very heavily in favor of those say, Look, I think X is a fair market rental as opposed to the developer who is arguing for X-plus.

Mr. **Adams**. There might be some other objectives that I wanted to achieve. Maybe there is a minority developer who isn't that experienced. He might need a little flexibility. Maybe there is an inner-city neighborhood that we really want to help revitalize. And it might be nonprofit. It might be a little more risky. But these are factors that could be evaluated so that you could defend what you did. If you did an award to the lowest fair market rent.

Senator **Bryan**. As this process were to determining the fair market rental, was the decision made at the local level and then kicked up regionally then to Washington? Or did it come the other way around?

Clearly, you have described the influence that the politically connected developers had.

Mr. **Adams**. The allocation was politically influenced, and then we had to prepare the application and get from the developer the numbers, the rents, the costs. We would analyze those.

But all of our projects that didn't have coinsurance required HUD approval, so we would send it to HUD.

Senator **Bryan**. My question is more specific, Mr. Adams. I know you were, in effect, told this is the developer. This is the project specific, I believe was the language that you used in the testimony.

But, as that developer put the package together, if the rental prices were so out of line, didn't the local housing authority or the housing entity have responsibility to recommend or to comment or to advise HUD that these rents are out of line based upon comparable rents in the neighborhood or the area?

And my question is, if you agreed that you did have that obligation, was that done?

Mr. **Adams**. We did not know. No one ever told us at the Federal level to submit fair market rents in X-dollars.

I think what we did and, again, I didn't personally process it, but I think what we did is we would look at the fair market rents in what was in that neighborhood. And we would also look at the cost of—the cost and make some recommendations if they were over what was in the neighborhood. We either did or should have justified why we were recommending higher numbers.

Senator **Bryan**. Let me try it another way, Mr. Adams.

What was done if in looking and evaluating a project that had been given to you, this is the project that we are willing to fund, when you saw rents that appeared to you or if you didn't specifically do that, the agency saw rents and the talk around the office is: My God, did you see what kind of rents they are asking for on project X—what was done, if anything, to advise the regional office, if that was the one that you next communicated with, or the national, that these rents are not justifiable in this area.

Our recommendation would be, if this project is to be approved, that the rental values be reduced by X-amount.

Did that even occur?

Mr. **Adams**. I would hope that we never submitted anything we didn't fell justified. I don't know how it worked in every specific. But what should have happened if it didn't is if we didn't think it was a valid fair market rent, we should not have submitted it to the Federal Government. There is that local responsibility.

Senator **Bryan**. My time is up.

Was there a breakdown at the local level as well in terms of advising Washington or the regional offices to the accuracy of those fair market rentals that were being submitted?

Mr. **Adams**. To the best of my knowledge, not in Dade County. But, again, I don't have personal knowledge of the reviews. But, if there was, if we submitted rents that were not justified at the local level, we shouldn't have done that.

Senator **Bryan**. Mr. Adams, thank you very much.

Mr. Chairman, thank you.

Senator **Graham**. Thank you very much, Senator.

Senator Shelby.

Senator **Shelby**. Thank you, Mr. Chairman.

When we are talking about oversight and dealing with HUD in this program, actually, a better term would have been that there was no oversight to speak of.

Would that be fair, Mr. Adams?

Mr. **Adams**. Yes, Senator.

Senator **Shelby**. So, when we see the term what they have done in oversight and what they should have done, it's two different things, isn't it?

Mr. **Adams**. Yes.

Senator **Shelby**. Let me ask you this.

Do you have a figure basically on how much money has been abused, misspent, misused here that we could have spent somewhere else? Just roughly.

Mr. **Adams**. All I know is what I have read.

Senator **Shelby**. That's OK.

Mr. **Adams**. It probably is in hundreds of millions.

Senator **Shelby**. Hundreds of millions of dollars. If we had spent that money on the homeless, for example, in this country, which are everywhere, or if we had spent that money on programs for the elderly or other areas of housing that people really needed and had merit, we would have done the taxpayers' justice, wouldn't we?

Mr. **Adams**. Yes, Senator Shelby.

Senator **Bryan**. Or if we had not spent the money at all rather than misspent it and cut the taxes of the taxpayer some way, or borrowed less money from the Japanese banks to fund our Government, we would have been that much better off, wouldn't we?

Mr. **Adams**. Yes, I was here in May when you were talking to some of your namesakes and others.

Senator **Shelby**. Sure.

Mr. **Adams**. They said this money——

Senator **Shelby**. The other Richard Shelby. Remember, he's from Oklahoma, a Republican? And I am a Democrat from Alabama.

Mr. **Adams**. You made that clear in May. But all of the consultants would say, well, it didn't come out of the project. But whether it came out of the project or not, if it came out of the developer's pocket, then he could have done the project for that much less.

Senator **Shelby**. You're making a good point and it should have been made long ago. That was as you were here, that was just about everyone of them that sat at this table. And the ones that didn't, they said, oh, it was not taxpayers' money.

You know and I know indirectly it is because it goes into the aggregate, doesn't it?

Mr. **Adams**. Yes.

And when Senator Bryan asked what I might do in terms of reviewing that, it would be one of the things, if someone can afford to pay $1,000 a unit to a consultant, then that developer can afford to do the project for $1,000 a unit less.

Senator **Shelby**. So the victims, and there are victims everywhere, this is not a victimless situation, the victims first are the taxpayers; and, second, the victims would be the homeless or the elderly or other projects that would have benefited in an honorable way mankind here in America, wouldn't it?

Mr. **Adams**. That's true. And I think, basically, when government operates like that, we are all victims.

Senator **Shelby**. We are all victims because less and less credibility is attached to whatever we do, isn't it?

Mr. **Adams**. Yes, sir.

Senator **Shelby**. Do you know in your lifetime in dealing with housing a more blatant example of influence peddling on a grand scale, on a national level, than dealing with housing?

Mr. ADAMS. I would say no. And also for a special reason. This was not like some other housing programs where the Federal Government and the developer worked together. These were funds that came to local government. Local government doesn't need a developer's consultant to lobby for us.

Senator SHELBY. I was thinking of hard work for money. People work hard. Millions of Americans every day, whatever their occupation is. But, when you can make millions of dollars by just a few telephone calls—from the evidence, and the evidence has been before this committee and other committees in the Congress—I can't think of anybody that has made that kind of money by just picking up the receiver and dialing a few numbers.

Can you, sir?

Mr. ADAMS. I never have.

Senator SHELBY. Do you know anybody that has ever made that kind of money and they claim it is legitimate and legal within the bounds of—I don't know if they have said in the bounds of propriety. I would hope not. By these consultants from former Secretary Watt all the way down that were well-connected and, obviously, now well-heeled Republican fund-raisers and party stalwarts.

Mr. ADAMS. Other than those consultants, I don't know of anyone.

Senator SHELBY. Do you know of any other agency in the Government that has had the influence-peddling that HUD had under Secretary Pierce? I know we've got scandals in Defense and so forth, but I am speaking of other agencies, like Commerce, Agriculture.

Mr. ADAMS. No.

Senator SHELBY. Nothing on this grand scale, is there?

Mr. ADAMS. Not on the domestic scene.

Senator SHELBY. Sir, how would you recommend to HUD if you were making a recommendation to come about oversight of their program, assuming that their oversight is meaningless, and we know that.

Mr. ADAMS. Well, I, again, would go back to fair share. I said in my opening testimony and you weren't here, I think the section 8 Mod Rehab Program properly administered is an excellent program.

Senator SHELBY. Let's go back to your words, "properly administered".

Now, how is that going to be done?

Mr. ADAMS. Fair share. When there was fair share, these developers never hired high-priced consultants. A fair share, Senator Graham read what the law said about fair market rents and strictly enforced that. It can be done. And I think at the local level or the State, if they are doing it for some smaller jurisdictions, we at the local level ought to analyze the developers' numbers and make sure not only that they are fair market rents but that the benefits that the developer is getting are not excessive.

And if they are, maybe the fair market rents can be a little lower than what is in the community.

It doesn't take any genius to administer a program if you want to.

Senator **Shelby**. It takes an honest person, doesn't it?

Mr. **Adams**. Yes. Maybe it takes someone who is not that smart. [Laughter.]

Senator **Shelby**. I hope they would be smart enough to out-smart the people that can ring up and make millions.

Thank you, Mr. Chairman.

Senator **Graham**. Thank you.

Senator Riegle.

DADE COUNTY PROJECTS

The **Chairman**. Mr. Chairman, I want to go through a little bit more data with respect to some of the projects that were actually done in Dade County. I want to read from a memorandum that touches on this point. This is a memorandum that was dated June 28, 1985 and was sent from you to Muriel Marty, your director of housing programs.

In that memo which you sent, it said as follows:

> On March 26, 1984, Mr. George Bellanos submitted a 201 units project which was added to the pipeline list. On January 3, 1985—

And this would be nearly a year later—

> We received a phone call from the Jacksonville area office asking us to submit a section 8 application and budget for 201 units. Exactly the same number.
>
> We reviewed the pipeline list and except for the Bellanos project, there was no other project or combination of projects that equalled 201 units.
>
> Therefore, we submitted an application and budget for the Bellanos project. This was the proper decision.

And then I will not quote further from your memo.

Now, was this the type of—the kind of site specific allocation that we are talking about here? Is this how this worked?

Mr. **Adams**. Yes.

The **Chairman**. So somebody somewhere else then decided that they wanted to fund that project and it happened to be 201 units, and so you get the message coming back down though you've got 201 units. And so even though that person might not be at the top of the list, they may be way down the list, nevertheless, at that point, they get moved to the top of the list.

Mr. **Adams**. Or they may not have been our preferred project.

The **Chairman**. I understand. In this case, do you recall offhand whether that one was a preferred project?

Mr. **Adams**. We never—we never developed what our preferred projects were because it wouldn't have done us any good. But I know that one was not at the top of the list.

The **Chairman**. Now, let me read you another short excerpt from the inspector general's audit of the Dade County section 8 Mod Rehab Program and ask you to respond.

> The Dade County assistant director stated that funding from HUD headquarters was intended for certain developers. He reached that conclusion since certain developers were able to furnish a copy of the notification from the Assistant Secretary for Housing to the Regional Administrator revised fund assignment or by other information before—

And I emphasize before—

> Dade County was notified of the funding by Jacksonville HUD field office. The information included specific Mod Rehab units for Dade County.

Now does that excerpt line up with your understanding of the events in Dade County?

Mr. ADAMS. Yes. And it was usually before the area office heard about it.

The CHAIRMAN. So, not only were these decisions being prewired in Washington, but the people who were getting these preferred project allocations found out about it even before you did, or other officials that were in the chain of command who would have to carry it out.

Mr. ADAMS. Yes.

The CHAIRMAN. Now let's take a look at some of these. Some of the Dade County developers who received Mod Rehab units during this period were consultants. We have gone back and tried to reconstruct who these consultants were and how much they were paid.

Note, for example, on the 292 units called Arama Limited, the developer paid in this case a consultant, Mr. Lewis Nunn, the former Kentucky Governor, $150,000 for consultant services.

And another $225,000 for attorney services. You know, that is more than we pay the President of the United States in an entire year for his work, just in terms of whatever these attorney services were.

Now, Mr. Nunn, in turn, paid John Mitchell, the former U.S. Attorney General, now deceased, $75,000 for his assistance for the project.

Were you aware at the time that such hefty consultant's fees were being paid with respect to Mod Rehab projects that were being developed in Dade County?

Did it come to you as a shock to find out that people like this who had political influence were raking off huge sums of money?

Mr. ADAMS. I initially thought the kind of political influence was they knew someone. They were contributors. They got the word across. I then heard maybe a year or so later than the word in the street was you pay $1,000 a unit, you get your project funded.

The CHAIRMAN. We have done some work on that and the numbers work out pretty close to that. Let me give you an example here, and I will give you a list.

On some of the projects, Park Tower, in the Park Tower project, the developer was M. Fine and Jay Kizlak. The consultant in this case was EMF Associates and Richard Shelby. You remember Richard Shelby. We had him as a witness here before this committee.

Shelby—not the Shelby on this committee, I might say—received $225,000, so he basically got what we pay the Presidents each year for a full year's work, on that deal.

Then you drop down to West Dade Limited, developed by Mr. A. Martinos and Mr. R. Burarro. The consultant here was Phoenix Associates and the guy that got the big fee was Joe Strauss. We have also had Mr. Strauss in here as a witness. He got $100,000.

You drop down Arama Limited, Louie Nunn received the two payments, $275,000. And then you go to Sea Grape Village, developed by Jay Perez and S. Ross. The person here who got the consulting fee was a fellow named G. Kisner. He turns out to have been a former HUD employee, not surprisingly. He got for Sea

Grape, he received $56,000 as a consulting fee, and for Polynesian Village, $42,000.

Now you add just those consulting fees up, $798,000, and those projects I listed account for 1,417 units. So doing the math, that works out about to $1,060 per unit.

Now this comes in pretty darned close to what you say was the word that developed out on the street, that these units were worth roughly $1,000 per unit to whoever wired the deal.

Is that correct?

Mr. ADAMS. Yes.

The CHAIRMAN. Are you an attorney?

Mr. ADAMS. No.

The CHAIRMAN. I'm not an attorney either. But we live in a society where you have to think like an attorney to approach a lot of these issues.

If these programs end up operating in this fashion where somebody who has wired on the inside can go ahead and get the project approved for a certain developer, go around the procedures, they, in turn, collect a big fee for using their political influence.

At the same time, other people out there who are waiting to try to receive the benefits of these programs are shut out. They don't get to participate, whether it is a different developer or the end user. Some poor person somewhere in some city gets shut out because the game is rigged and it is rigged for somebody else, in effect, against them.

Doesn't that strike you as being illegal and improper?

Mr. ADAMS. Yes, sir.

The CHAIRMAN. If you have a Federal program lined up to send help out on a fair basis to everybody out there who is in need and somebody gets on the inside and wires the game and diverts the money off to a selected group at the disadvantage of the rest, wouldn't you think that was illegal?

Mr. ADAMS. It certainly is immoral and improper.

The CHAIRMAN. Suppose you saw a pattern of it. Suppose you saw not just an isolated incidence here or there that might lend itself to some kind of an explanation of sort of a random event, suppose you saw a pervasive pattern where this was being done time and time and time again.

Wouldn't you say that that was illegal and improper?

Mr. ADAMS. I am trying to answer every question. I just don't know. I'm not a lawyer, so there may be some laws.

The CHAIRMAN. Are you surprised now, however, as a professional in the field and shocked to see the extent to which this was going on? Did you ever imagine that it would go on to this extent?

Mr. ADAMS. No. And I think payment of those amounts of money is unconscionable. It is every bit—I mean, the irony of all this is that a program that was good that the administration tried to kill by direct action, they seemed to have at least temporarily succeeded by killing it by terrible administration.

The CHAIRMAN. And they did something else. They decided when they couldn't kill it that they would take advantage of it and they would milk the program and bleed the program to drain the money off in very large measure for themselves and for their friends, because a very substantial number of the people who got these huge consulting fees first worked in HUD. They left HUD-Washington.

They went out and then they got on the receiving end of this rigged game, and ended up earning—I say earning. I don't think they earned it. But they ended up deriving these very huge consulting fees.

So you have a situation here where some of the very people who are inside the Government, when they couldn't kill the program, they went out and, in effect, directed the programs to themselves. And quite, I think, and I think it is a deliberate steering away from what the law required and had in mind. I mean, I think that is where there is a real question of a violation of law because I think, instead of allowing this program to go to its intended beneficiaries, they twisted it off course in a way that allowed them to clean up personally.

Mr. ADAMS. Although I have no personal knowledge, I really believe that—I agree with you, it was a conscious decision at some level of HUD to reward our friends.

The CHAIRMAN. Especially when you see this kind of pervasive pattern.

Thank you.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. I would like to pursue that and then come back to the question of your suggestion of remedies.

You indicated that while Dade County did not have a priority list, that there were some general standards that you were trying to accomplish within a community-based housing program.

Is that correct?

Mr. ADAMS. Yes.

Senator GRAHAM. Could you describe how the actual process of directing funds through the method of messages from Jacksonville and Washington as to which projects were going to be approved, did that advance, pervert or have irrelevant influence on your plan?

PROCESS OF DIRECTING FUNDS

Mr. ADAMS. It was totally unrelated to what kinds of priorities we would set. In Jacksonville, we're strictly a messenger. They have no judgment in the process. I would have wanted to see more family housing under the Mod Rehab Program. I would have wanted to see—I say I—we would have wanted to see more minority, black minority, involvement. We would have wanted to see more of the units helping to revitalize neighborhoods like Overtown and Liberty City. And we would have wanted to see that we got the best bang for the buck.

And when it was fair share, none of these developers paid any consultant fees because there was no one to lobby.

Senator GRAHAM. I would be interested in—and you are testifying about Dade County. And that is a community I know well, but it could be applied to other communities.

What would have been the consequence if the same number of dollars had come into Dade County and had been applied against the standards that you have just described? More families, more minority, more inner-city, as opposed to how that amount of money was applied.

Who were the losers in this directed project process?

Mr. **Adams**. I wouldn't say the same units. The same dollars that came in. Then all would have gotten more units because we would—and if it were our fair share, which was more than our fair share. But, if we got the same dollars, you wouldn't have had the consultants and, therefore, we could have gotten more units for the dollars.

I think we would have done more in Overtown. We would have done more in Liberty City and in some of the other, smaller inner-city neighborhoods that are scattered throughout Dade County. It was an excellent program to help revitalize the inner-city and to try to get some black minority developers.

Senator **Graham**. Let me go back to the question of your remedies. In your submitted statement, you give as one of your areas of suggested improvements that there should be a plan identifying the percentage of funds to be allocated between elderly and family housing.

Did you have as part of your local plan an allocation between elderly and family? And was there any sensitivity to that allocation under the directed approach which HUD utilized?

ALLOCATION OF UNITS BETWEEN ELDERLY AND FAMILIES

Mr. **Adams**. Under the fair share plan, we did submit that kind of breakdown and it was related—it gets technical, but the community development program requires a housing assistance plan where you look at your community, decided your needs.

And then we put that money out based on that plan. Dade County and every other community still had a housing assistance plan which indicated needs by family, elderly, large families. But the allocation under the directed approach from Washington paid absolutely no attention to the housing assistance plan.

In fact, I can't remember his name, but one developer came in and said: If I can get this project funded, will I get the funds?

And I looked at the list and I said: No, because someone is ahead of you.

He said: Fine, I will get more projects in Puerto Rico funded.

And that was the last I ever saw of him for that project.

Senator **Graham**. When a developer received funds, was there a commitment as to the characteristics of the tenants to be served either by description of who they would be—elderly, handicapped families. Or by the nature of the unit itself more or less dictating who the tenant would be.

Mr. **Adams**. If it were an efficiency unit, it would obviously be elderly. If it were one bedroom, it would invariably be elderly. And I think the bulk of the units were efficiencies and one bedrooms. If it was two bedroom, it could be either family or elderly.

But we never set the criteria. Under fair share, you could set the criteria. You could say two bedrooms, first priority goes to families. And if you can't rent it to families within X-period of time, then you can use elderly.

We have a lot more potential for shaping the nature of the program when we control who gets the units.

Senator **Graham**. Would it be your sense that after fair share was eliminated that the number of units available for families as a percentage of total section 8 Mod Rehab declined?

Mr. **Adams**. Yes.

Senator **Graham**. I would assume that it would be less costly to a developer to operate a unit for elderly than it would for families. Maintenance would tend to be less; at the end of the 15-year period of contract with HUD, your unit probably is more valuable since it has not been subjected to the additional stress that a family would tend to provide.

Was there a differential in the way the rent structure was set that recognized those factors?

Mr. **Adams**. I would doubt it. I don't know from personal knowledge, but I would doubt that there was any differential.

Senator **Graham**. So, another way in which the fair market rent was perverted was by providing for no recognition of the differential in cost and value of property and at the end of the rent contract as between the elderly and families and then a system that tended to reduce the number of units available to families.

Mr. **Adams**. That is correct. You asked me earlier a question about what some of the benefits were to developers. Back then, certainly the tax code was much more beneficial than it is now, which you all will deal with in another time.

If the capital gains is reduced, it would make it even more profitable for developers of assisted housing to sell them at the end, which is a problem with the 221-D3's and others that you were all worried about.

The **Chairman**. If you would yield, Senator Graham.

Senator **Graham**. Yes, I yield.

The **Chairman**. That raises an idea. I don't know if it can be done. But, in the case where there were these improper allocations of units, where developers not only got these favors but are sitting out there with these projects and likely to get another windfall if the capital gains rate is dropped. It almost seems like one way that we ought not to allow the capital gains rate to drop at least on those projects.

I'm not sure that we can do a carve-out that way. Usually, the carve-outs are the other way. But, you know, that will really add insult to injury, it seems to me, if people who got these projects improperly, and getting another windfall based on the capital gains tax reduction.

Senator **Graham**. I certainly agree with that. The section 8 Mod Rehabilitation Program provides for periodic rental adjustments.

Is that correct? Over the 15-year period?

Mr. **Adams**. Yes.

Senator **Graham**. Normally, you think of those adjustments as being on the additive side. Is there any reason why those adjustments could not be a reduction of rent if there were some change in underlying external conditions, such as the restoration of capital gains that would make the project more valuable and, therefore, not require such a high rent to support it?

Mr. Adams. Well, you could do that. You are catching me cold. One problem I see is that you would want—you clearly want enough rent so that the properties are well-maintained, both day to day and for replacement.

But, in terms of the return to the developer, you could adjust the rents to reflect any capital gain benefit. You could hold down the rent increases below what might normally go. But you don't want to end up squeezing the developer so much by the owner that the property can't be maintained.

Senator **Graham.** Excuse me. I recognize the red light is on.

Once you have signed a contract with the developer, I assume that the developer has contractual obligations to a level of maintenance.

Mr. **Adams.** Yes.

Senator **Graham.** And it really then becomes a matter of oversight supervision and management to assure that the developer lives up to his contractual obligations which he entered, not only in this case freely and openly but was willing to pay $1,000 a unit to get the privilege of entering into that contract.

Mr. **Adams.** Yes.

Senator **Graham.** Correct?

Mr. **Adams.** Yes.

Senator **Graham.** I guess I'm not too sympathetic that you have to be inducing him with constant rent increases to fulfill his obligations. Maybe he ought to go back and collect $1,000 a unit to make some of those maintenance items if he can't otherwise do it.

Senator Bryan.

Senator **Bryan.** Thank you, Mr. Chairman. Just a couple of questions.

Mr. Adams, let me return to the fair market rental question that I asked earlier. Given the project-specific type allocation as opposed to the fair market, the overall allocation that you talked about in terms of fair share, once you are assigned that project, did you ask the local housing authority how to certify as to the fair market rentals that were incorporated in the developer's project?

Mr. **Adams.** I don't know if certification is the right word. We had to analyze the project based on the rehabilitation cost, the other cost, cost of the property, what rents it would take to support it, what the mortgage would be and all of that. And we had to justify that if it were over the fair market rent, explain why we felt that it was justified and then submit that to the HUD area office.

Senator **Bryan.** Now, with respect to the projects that Senator Riegle was asking you about, and I realize that you may not have independent firsthand knowledge, but pretty clearly from those numbers as developed, they were heavily padded to accommodate the extraordinary consultant's fees that the developers were paying to these people that are politically connected that were able to get their projects to the top of the list.

I am correct in that assumption, am I not?

Mr. **Adams.** Well, we certainly—whatever they say, it came out of the project.

Senator **Bryan.** It came out of the project, that is to say, but for those incredible consultant's fees, unconscionable in my view, the rental values would have been less.

Mr. **Adams**. Yes.

Senator **Bryan**. Now, assuming that that is the case, there clearly had to be some obligation on the part of the local folks that were managing HUD projects to at some point in time question the amount of those rents. It would seem to me, Mr. Adams, and I don't ask that to you specifically that that was your responsibility within the agency that you had—I don't know who did, but clearly, when you look at those fair market rental values, it would seem to me that something would say wait a minute, those are far higher than they ought to be.

Mr. **Adams**. Again, I would have to—in theory, I would agree with you. I would have to look at a pro forma, but none of them ever listed these consultants.

Senator **Bryan**. I understand, Mr. Adams. Your testimony I think was clear that initially you had no idea that these extraordinary consultants' fees were being paid. But the mass would ultimately add up for whatever reason to a number that would be higher I would think than could be justified based upon the knowledge that a local housing authority would have, that those rents are higher than comparable rental units.

EXORBITANT RENTS

And, therefore, I would think at some point in the line, there would be an obligation to alert somebody: Look, these rents are too high. Something is wrong. Don't know what is creating these inflated costs, but something is wrong. And, yet, seemingly, that did not occur anywhere from what we are able to gather.

Mr. **Adams**. I suspect that in many jurisdictions, and Dade County may have been one, that the view was that the Federal Government had to approve the numbers anyway. And it wasn't—there wasn't a sense of using a fine-toothed comb to go through the numbers.

So, probably, the answer to your question is mainly yes.

Senator **Bryan**. Where I am coming from, Mr. Adams, is that, clearly, the conduct of the Washington office was reprehensible. They corrected the process. Nobody in my judgement can defend that conduct. And I'm not trying to excuse their actions. But it seems to me as we look at this whole system and try to rebuild it and do something that will be responsible, you're saying fair share.

If we go back to that, we at least eliminate the influence peddling, the kind of fees that have been testified to previously before this committee and which are public knowledge.

And, yet, I must say that it seems to me that, at some point, there is the responsibility of the folks at the local agency level when they see something awry. Maybe ignorant as you all were initially, that there was a consultant fee arrangement here that was far in excess of anything that previously had been involved.

But there has to be some responsibility at the local level to let folks at the regional and at the national level, assuming that they are playing the games by the rules, and in this instance, I would agree that they were not, Mr. Adams, that these rents were out of line.

That's where I keep coming back to. Only the local agency will have a feel of what property values are. I am from Nevada. I have no idea what rental values are in Dade County. Were I looking at a project in Nevada, I would at least have a sense because it is a community that I have lived in all of my life, and I would presume that there is some responsibility in the local entity to, in effect, when that application is going out, to at least certify, to sign off, to make some kind of honest assessment whether those rents are fair or not, even it we go back to the fair share concept.

Mr. ADAMS. I think that at the local level there is that responsibility. And to the extent that local government did not do that, then local government contributed to the problem.

The HUD area office and HUD in most other programs never had a problem second-guessing what local government does. In this program, it seldom second-guessed.

So I agree to the extent that we didn't do the job the way we should have, then we contributed to part of the problem.

Senator BRYAN. Mr. Adams, my last question. I notice that you were President of the National Association of Housing and Redevelopment Officials from 1985–1987.

At some point in time long before the public became aware of it, long before I suspect that Members of the Congress became aware of it, you all must have had a network. You met periodically, annual meetings, regional conferences. Wasn't there some discussion that this program is out of control? That its purpose has been perverted from what it ought to be? Wasn't there some kind of discussion among your professional colleagues?

You strike me as a man who is sincerely interested in these kinds of programs and are offended personally by what occurred.

Didn't that knowledge become available to those of you that were working at the local level?

Mr. ADAMS. It became available, but let me give another side of it. As President of NARO and before that, I was fairly outspoken in terms of what I thought of the administration's housing programs. As a result of that, I think I personally got punished by HUD.

We got very little moderate rehabilitation to keep our public housing up. We got no new public housing. My phone calls weren't returned. I heard from Senator Graham's predecessor: Don't expect as long as he is in Dade County, don't expect any help from that office. And things of that nature.

After a while, sometimes people at the local level just keep their head down. I don't believe in that. I would do it again. But I paid a penalty.

Senator BRYAN. I don't mean to be unduly harsh with you, sir. I guess what I am saying is that for most of us this was somewhat of a revelation when these numbers began to unfold.

It seems to me that there is a responsibility when people who are professionally committed to these programs, as I believe you to be from your testimony and seeing you here this afternoon, if somebody could have waved the flag and said, wait a minute. This program is careening out of control. Not only do we disagree with the philosophy of the administration, one can reasonably argue and debate the hot philosophies.

But, to, in effect, destroy a program through a systematic corrupt practice as this, it seems to me somebody ought to have been standing on his or her feet and saying this is wrong and we've got to call this to the attention of the oversight committees and the Congress.

That is my only point.

Thank you very much, Mr. Chairman.

Senator GRAHAM. Thank you, Senator.

Senator Riegle.

The CHAIRMAN. I was only going to finally say:

At any time, did you or your colleagues ever think about reporting what you were seeing to either the inspector general or to the district attorney in that area?

Mr. ADAMS. I don't know if anyone did think about it. Just speaking as someone who felt the need for housing in Dade County, even if it wasn't the housing that I would have preferred, it was housing that took care of people. And I thought it was not right but it was benefiting people that I was trying to provide housing for.

So, never once, when HUD gave us an allocation, did they ever say on your list, who do you think—what is your preferred——

The CHAIRMAN. The people that wired this game did it very cleverly because they had a situation where local officials, even if they didn't like it and even if it was the wrong priority and even if there was blatant favoritism were probably going to accept the projects because it was better than nothing.

Mr. ADAMS. Yes. Had I "blown the whistle," that's what I would have gotten: Nothing.

The CHAIRMAN. Thank you, Mr. Chairman.

Senator GRAHAM. Thank you.

Just to conclude, Mr. Adams, I want to thank you for what has been some very candid and illuminating testimony. You indicated in response to Senator Bryan's concluding questions that there was some degree of punishment inflicted upon you and the agency that you headed because of your public statements relative to the housing programs.

That statement in context of the fact that, as Senator Riegle suggested, Dade County received what would appear to be an overly generous share of section 8 Mod Rehab would seem to indicate that maybe there was a practice of benefiting individual developers and applicants.

But punishing the agency and, therefore, those who did not have a preferential relationship with a well-heeled and well-connected developer.

Is that what you were saying?

Mr. ADAMS. Yes.

Senator GRAHAM. Beyond what you have said, do you have any further specificity as to the way in which that punishment was meted out?

Mr. ADAMS. Well, I think we just didn't get help that we needed in public housing. And, beyond that, I'll leave it at that.

Senator GRAHAM. As you know from your period there, and since you left Dade County, there has been a series of major scandals—grand jury investigations, other agency investigations relative to public housing in Dade County, particularly to the inadequate level of maintenance of the public housing stock.

Do you believe that some of those problems go back to this period of punishment directed against you and the agency?

Mr. **Adams**. I do. But there is no way of proving it. In my opinion, it cannot be proven but the HUD people knew what I was doing. And I heard from an undersecretary that I was too outspoken. And Ms. Dean made some comments to me once.

Senator **Graham**. As the chairman indicated in his preliminary statement, we're going to have those people before this committee and we will see if it is possible to determine whether there was such a pattern in your case or in any other agency which raised objection to the way in which housing programs were being managed.

Are there any further questions?

[No response.]

Senator **Graham**. Thank you.

[Witness excused.]

Senator **Graham**. Panel two is John C. Weicher, Assistant Secretary of Housing and Urban Development, and Mr. James Logue, Deputy Assistant Secretary for Multifamily Housing Programs.

Would you please rise and raise your right hand?

Do you swear that the testimony you are about to give is the truth, the whole truth and nothing but the truth, so help you, God?

Mr. **Weicher**. I do.

Mr. **Logue**. I do.

[Witnesses sworn.]

Senator **Graham**. Thank you.

Mr. Weicher, are you going to testify first?

Mr. **Weicher**. Yes, I think so.

STATEMENT OF JOHN C. WEICHER, ASSISTANT SECRETARY FOR POLICY DEVELOPMENT AND RESEARCH, HUD, WASHINGTON, DC

Mr. **Weicher**. Mr. Chairman, members of the committee, I appreciate the opportunity to appear before you and explain the process of developing fair market rents in HUD's existing housing programs.

We have a basic set procedure for establishing fair market rents in the section 8 voucher and certificate programs. We have a separate procedure, a separate set of statutory and regulatory guidelines which are used in the section 8 Mod Rehab Program.

The Mod Rehab Program rents are tied to the section 8 existing fair market rents. But the guidelines, the separate guidelines, result in quite distinct calculations.

And I want to begin by describing the basic process and then talk about this separate process that is used in the Mod Rehab Program.

In addition, we prepared for the record a more detailed explanation of the data and methodology that we use in calculating fair market rents.

I want to begin by emphasizing that the fair market rents are carefully developed using the best and most recent available data that we have on rents for housing in the United States.

In addition, there is public comment process to identify areas where fair market rent estimates can be improved. The section 8 existing housing program fair market rents are the ceiling rent schedules for determining the eligibility of rental housing units for the certificate programs. They also serve as the payment standard used to calculate subsidies under the housing voucher program.

They represent the typical cost of rental housing available in the private market. They're calculated on an annual basis for the 339 metropolitan areas in the United States and for 2,416 nonmetropolitan counties, a total of 2,755 fair market rent areas in the United States.

The objective in setting fair market rents is to assure that a sufficient supply of rental housing is available to accomplish this objective. Fair market rents must be both high enough to permit a selection of units in neighborhoods and also low enough to enable as many low-income families as possible to find modest but decent housing.

The level at which fair market rents are set is expressed as a percentile within the overall rent distribution of standard quality rental housing units.

The percentile standard uses a 45th percentile rent for recent movers. That is the dollar amount below which 45 percent of standard and quality rental housing units are available on the market.

This 45th percentile is drawn from the distribution of rents of units occupied by households who moved within two years of the rent survey that we used for an area.

The distribution of rents excludes public housing units as well as units built within 2 years prior to the date of the survey and also an adjustment is made to eliminate the effect on rents of units that do not meet HUD's housing quality standards.

FMR's are based primarily on decennial census data, American housing survey data and the consumer price index rent component; for all areas, the fair market rents are rebenchmarked every 10 years when the results of the decennial census becomes available.

In addition, all fair market rents are updated annually with the relevant rent component of the Consumer Price Index. That is available for 72 separate individual metropolitan areas and further it is available for the four census regions in the United States. We use those 76 rent indexes.

There are also 44 large metropolitan areas where we have an American housing survey. We survey 11 of those areas every year over a 4-year cycle.

And the fair market rents for those areas are rebenchmarked every 4 years when the American Housing Survey becomes available. The American Housing Surveys are conducted for HUD by the Bureau of the Census and have the same degree of accuracy as the decennial census of housing.

The area is covered by the American Housing Surveys and they represent about one-half of the renters in the United States. Fair market rents are published in the Federal Register each year. They are published as proposed estimates to invite public comments and later published for final effect.

The proposed fair market rents are usually published in mid-April. There is a 60-day comment period; finally, fair market rents are made available, are made effective by October 1 of each year, at the beginning. So they are available at the beginning of the next fiscal year for units that can be subsidized that year.

The purpose of the public comments is to identify areas where the fair market rents are not thought to be appropriate. Most comments are submitted by public housing authorities or other organizations responsible for operating the section 8 programs.

The comments must include statistically valid rental housing survey data to justify the recommended changes. About half of the comments that we received actually result in revised fair market rents.

The fair market rents as established by this procedure can be modified for other reasons. A public housing authority can request HUD approval to permit use of fair market rents that are up to 20 percent higher than the published fair market rents. Increases for this reason may not apply to more than 50 percent of the fair market rent area. They are usually requested to cover portions of the fair market rent area that have rents much higher than average for the FMR area.

At present, there are 81 approved exceptions located in 60 fair market rent areas. For the most part, the exceptions cover only small parts of the entire FMR area.

There is another process used to grant fair market rent exceptions for a limited percentage of individual units. That is described in the background statement and it is not really relevant to the Mod Rehab Program.

May I take a moment to explain this special aspect of the Mod Rehab Program here?

Senator **GRAHAM**. Yes. Please.

Mr. **WEICHER**. All right. In the Mod Rehab Program, fair market rents are first based on the fair market rents for vouchers and certificates. The published Mod Rehab Program rent standard is set up 120 percent of the published section 8 existing fair market rent standard as used for vouchers and certificates.

Now that is a ceiling rent. It has to be justified for individual projects. There is no automatic guarantee that any Mod Rehab project will receive a rate of 120 percent of the voucher or certificate fair market rent. It has to be justified on a case by case basis.

In addition, as I mentioned before, there was an exception rent process calculated in a different manner than in the basic section 8 voucher certificate program.

In an area where exception rents for section 8 vouchers and certificates have been approved, Mod Rehab rents may be increased by up to 10 percent with HUD approval. If the exception rent increase in voucher and certificate program is less than 10 percent, then the Mod Rehab rent can be increased by only that small percentage.

If there is no significant section 8 existing program activity in an area where geographical exception is requested for Mod Rehab project, then HUD determines the appropriateness of the exception rent.

This geographic area exception can result in Mod Rehab rents up to 132 percent of the published section 8 existing rent for vouchers and certificates.

In addition, the Mod Rehab Program has a provision for an exception rent based on unanticipated but essential actual rehabilitation costs.

Public housing authorities may approve initial gross contact rents up to 10 percent above the rents approved by HUD. Rents may be increased by up to 20 percent instead of 10 percent with specific HUD approval.

This exception can result in Mod Rehab rents up to 144 percent on published section 8 existing rents. Under the current regulations, increases in Mod Rehab Program rents may not result in initial project rents any higher than this amount. No higher than 144 percent of the published section 8 existing fair market rents or 120 percent of the basic Mod Rehab fair market rents.

That concludes the description of the fair market rent setting process.

I will be glad to answer any questions you may have.

[The complete prepared statement of John C. Weicher follows:]

STATEMENT OF JOHN C. WEICHER
ASSISTANT SECRETARY FOR
POLICY DEVELOPMENT AND RESEARCH
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT BEFORE
THE SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS
9-18-89

FAIR MARKET RENTS (FMRs) FOR THE SECTION 8 EXISTING HOUSING PROGRAM

Mr. Chairman, Members of the Committee, I appreciate the opportunity to appear before you to explain how the proposed Section 8 Existing program's Fair Market Rents, typically referred to as FMRs, are developed. In addition, we have prepared for the record a more detailed explanation on the data and methodology used in calculating FMRs.

I want to emphasize that the FMRs are carefully developed using the best and most recent available data. In addition, we place heavy reliance on the public comment process to identify areas where estimates can be improved.

Overview

The Section 8 Existing Housing Program FMRs are the ceiling rent schedules for determining the eligibility of rental housing units for the Section 8 Existing Housing program. They also serve as the payment standard used to calculate subsidies under the Housing Voucher program. Section 8 Moderate Rehabilitation Program rents are also tied to the Section 8 Existing FMRs, but are subject to a separate set of statutory and regulatory guidelines. The FMRs represent the typical cost of rental housing available in the private market. They are estimated on an annual basis for the 339 metropolitan areas and 2,416 nonmetropolitan counties in the U.S.

FMR Standard

The Department's objective in setting FMRs is to assure that a sufficient supply of rental housing is available to program participants. To accomplish this objective, FMRs must be both high enough to permit a selection of units and neighborhoods and low enough to enable as many low-income families as possible to find modest but decent housing. The level at which FMRs are set is expressed as a percentile within the rent distribution of standard quality rental housing units. The percentile standard used is the 45th percentile rent for recent movers, the dollar amount below which 45 percent of the standard quality rental housing units rent. (This is slightly below the median.) This 45th percentile rent is drawn from the distribution of rents of units occupied by households who moved within two years of the rent survey used for an area. Public Housing units and units built within two years prior to the date of the survey used are excluded, and an adjustment is made to eliminate the effect on rents of units that do not meet HUD's housing quality standards.

Data Sources

In developing the FMR estimates, the Department uses the most accurate and current data available. FMRs are based primarily on decennial Census data, American Housing Survey (AHS) data, and Consumer Price Index (CPI) data. For all areas, FMRs are rebenchmarked every 10 years when the results of the decennial Census become available.

All FMRs are updated annually with the relevant CPI data that is available for 72 individual metropolitan areas and the four Census Regions. For the 44 largest metropolitan areas with AHS surveys, the FMRs are rebenchmarked every four years. The America Housing Surveys are conducted by the Bureau of the Census and have been designed to replicate the standards of accuracy of the decennial Census of Housing. The areas covered by the metropolitan AHS surveys cover about one-half of the nation's renters.

Public Comments

FMRs are published in the Federal Register each year. They are first published as proposed estimates to invite public comments, and later published for final effect. The proposed FMRs are usually published in mid-April, and there is a 60-day comment period. By law, the final FMRs must be made effective by October 1 of each year.

The purpose of the public comments is to identify areas where the FMRs are thought not to be appropriate. Most comments are submitted by Public Housing Agencies or other organizations responsible for operating the Section 8 program. To be considered for FMR revisions, the comments must include statistically valid rental housing survey data that justify the recommended changes. Approximately one-half of all comments received actually result in revised FMRs.

FMR Modifications and Exception Rents

Increases resulting from public comments are included in the FMRs published for final effect. Such changes are referred to as modifications to proposed FMRs.

A PHA may request HUD approval to permit use of FMRs that are up to 20 percent higher than published FMRs. Increases of this type may not apply to more than 50 percent of the FMR area, and are usually requested to cover portions of an FMR area that have rents that are much higher than average for the FMR area. Such increases are also referred to as geographic area exceptions.

The Department monitors these geographic area exceptions closely. At present, there are 81 approved exceptions located in 60 FMR areas. For the most part, the exceptions cover only small parts of entire FMR areas; in no event, may more than 50 percent of the population of a FMR area be covered. To be approved, the geographic area exceptions must be justified with rental market data which show that the average rent level in the exception area is greater than in the FMR area as a whole. There is another process used by PHAs to grant FMR exceptions for a limited percentage of individual units. I have not described it in this statement, however, because it is not relevant to Moderate Rehabilitation programs. An explanation is included in the background statement.

The appeals process to modify proposed FMRs and the exception process to deal with special situations within an FMR area are essential parts of the Section 8 Existing program. These processes permit FMRs to be increased where needed so that program participants can find standard quality rental units within the rent standard.

Thank you. I would be happy to answer any questions you might have.

BACKGROUND STATEMENT
SECTION 8 EXISTING HOUSING
FAIR MARKET RENTS

SECTION 8 EXISTING FAIR MARKET RENTS

Overview

Section 8 Existing Fair Market Rents (FMRs) are the ceiling rent schedules used for determining the eligibility of rental housing units for use in the Section 8 Existing Housing program. They also serve as the initial basis for calculating subsidies under the Housing Voucher program. Once housing units are in the program, annual adjustment factors based on Census Consumer Price Index (CPI) data are used to adjust for inflation.

FMRs represent the typical cost of rental housing available in the private market, and are established on an annual basis for all metropolitan areas and nonmetropolitan counties. FMRs are published in the Federal Register, first to invite public comments and then for final effect. Section 8 Existing FMRs are established by HUD's Office of Policy Development and Research. They are based on private market rent levels for standard quality housing, as measured by Bureau of the Census decennial Census data, American Housing Survey (AHS) data, and Department of Labor CPI data.

FMR Methodology

Background: The first FMR schedules were developed in 1975, based on updated 1970 Census data. In 1979, the Department began supplementing 1970 Census data with American Housing Survey (AHS) data to develop FMRs. This was the first year that data for all 59 of the metropolitan areas then surveyed by the AHS became available, and these data provided the opportunity to introduce a uniform and statistically accurate measure of the intercensal changes in rent levels for these large market areas.

The first AHS-based FMR estimates were established at the mid-point (i.e., the 50th percentile) of the rental housing distributions for local housing market areas based on the sample of units occupied by households that had moved into the units within the past two years, referred to as "recent movers". Only rental units which met the Section 8 housing quality standards were included in calculating FMRs. Since the most recent AHS data used in these calculations were several years old, the rents obtained from the surveys had to be updated. This was accomplished through the use of the CPI surveys of residential rent and of fuel and utilities available for selected metropolitan areas and for Census Regions.

In December 1982, the Department proposed moving from a 50th percentile recent movers FMR standard to a 40th percentile standard which excluded recently completed units and included all standard units rather than only those occupied by recent movers. In response to public comments, the Department compromised on a 45th percentile recent mover FMR standard in 1983 which excluded public housing and recently constructed units and used a new definition to define a standard quality unit. It also modified the manner in which FMRs for three or more bedrooms are calculated by providing larger increases above the two-bedroom standard, with the objective of increasing the success rate in placing larger families. The 45th percentile standard and associated definitions have been used since 1983. The FMRs published in 1986 were the first to take full advantage of 1980 Census data, which provided the opportunity for improving the accuracy of FMR estimates. For areas covered by AHS metropolitan surveys, AHS data are more current than 1980 Census data. This year's FMRs have incorporated all of the AHS metropolitan area surveys conducted through 1986.

FMR Levels: The level at which FMRs are set is expressed as a percentile within the rent distribution of standard quality units. The current standard is the 45th percentile rent, which encompasses nearly one-half of the rental housing stock in the local housing markets. The objective of the program is to provide standard housing at cost limits which are high enough to preclude subsidizing unnecessarily costly units at the expense of assisting more low-income families.

The level at which FMRs are set has three major impacts. First it determines the range of choices and quality levels available to program participants. Second, it effects program costs. Given that tenant contributions are related to income rather than housing costs and that HUD subsidizes the difference between eligible housing costs and tenant contributions, program costs are tied directly to FMR payment standards. Third, FMR levels serve to target program participation because the tenant contribution is generally 30 percent of household income. A household with an adjusted income of $12,000 receives a $100 per month subsidy if it resides in an eligible unit renting for $400, but no subsidy if the FMR standard is $300. A household with an income of $6,000, however, would receive a $150 per month subsidy even at the lower FMR level. In effect, this means that lower FMRs tend to target the program at those most in need of assistance by making the program less attractive to households at least marginally able to afford standard housing. If the FMRs are set too low, however, participant housing choices will be limited and there will be less incentive to upgrade marginal quality housing to meet program standards.

Selecting Units for Calculating FMR Standards: A primary determinant of what units are included in calculating the FMR is the definition of standard quality housing selected for use. An overly restrictive definition may exclude too many lower cost units and reduce sample sizes below acceptable levels. Inclusion of public housing units, as done until 1983, serves to understate their costs, since only the tenant-paid contribution to rent is recorded as the market rent. This, in turn, can have a undue downward bias on FMRs in areas with large public housing inventories. Inclusion of recently constructed units can result in setting FMRs at a higher level than needed to attain program goals, and thereby unnecessarily reduce the number of households that can be served within program budgetary limits. To correct for the bias, HUD excludes newly constructed units (i.e., those built within the previous two years) from FMR determinations.

Housing Quality Standards: The Department uses a statistical measure of housing quality developed from AHS variables to identify units that appear to have major deficiencies. Research measuring housing quality indicates that the current definition of inadequate housing used by HUD results in a close approximation of what the FMR estimate should be if questionable quality units are taken out of the calculations. In general, the difference resulting from this adjustment is relatively small, amounting to three to six percent in most areas.

The housing quality standard used in the first few years of the program was based on measures available from the 1970 Census. It was known that the AHS had a broader range of housing quality measures, and from 1979 to 1982 a definition of inadequate housing based on AHS data was used. This definition categorized a housing unit as inadequate if it exhibited one or more of 23 characteristics (e.g., a non-working hallway light fixture, peeling paint, rooms without electrical outlets). These characteristics were selected to replicate, to the extent possible, the Section 8 Existing Housing program housing quality standards.

It became evident that this definition had serious flaws. Forty percent of all rental units were identified as inadequate using this definition, which was far in excess of what was believed to be a credible level in most areas. A number of higher priced, more luxurious units also failed the HQS equivalency test. In addition, the percentage and identification of units that failed the standard varied significantly from year to year. The problem appeared to be partly related to the fact that AHS respondents rather than trained inspectors were providing information, and partly due to deficiencies that could be quickly and inexpensively remedied. It was clear that this definition excluded an unacceptably large number of standard quality units and thus reduced sample sizes below desired levels in smaller areas.

In 1983 HUD began using a new definition of inadequate housing considered to be the product of the best and most current research on this subject. The new definition identifies about 10 percent of all rental units in the survey as inadequate, and reduces the average national FMR by about three percent relative to the old definition. This definition provided estimates very similar to those from other definitions that were considered. It also produced the most stable and credible results when applied to time-series data from the AHS on housing quality of individual units over time.

Recent Mover Standard: The Department recognizes the fact that the rents of units that have turned over in the past two years have somewhat higher rent levels than the inventory as a whole. It was decided to base FMRs on a "recent mover" standard to facilitate the achievement of the basic legislative goals of the program to promote greater choice of rental housing among low-income families. Approximately half of program participants do search for and move to a different housing unit after becoming eligible for program subsidies.

Bedroom Size Adjustments: Nearly three-fourths of the rental housing inventory in the U.S. consists of one- and two-bedroom units according to the 1985 National AHS. Analysis of Census and AHS sample data show that the market-to-market rent differential relationship between these two unit sizes remains fairly constant, usually within a few percentage points of 15 percent. Our procedure, therefore, has been to concentrate on getting the best two-bedroom rent estimate we can and then applying the standard differential to obtain a reasonable estimate for one-bedroom units. This procedure permits us to produce better estimates for the bulk of the inventory, and most program participants, than would be possible if the same resources were used to produce separate estimates for all unit sizes.

Until 1983, the Department adjusted for large and smaller units using average national bedroom size price differential relationships. In 1983, because local PHAs were experiencing significant problems in placing larger families in the larger unit sizes, the Department decided to provide larger intervals for units with three or more bedrooms. The bedroom size adjustments used for three-bedroom and larger units typically produce higher FMRs than would result if based on use of a 45th percentile standard and actual market relationships. This policy is the result of the low success rate of large families in finding program-eligible units in the early years of the program. Large units in the rental market include those occupied by small families, who tend to be preferred as tenants over large families. The current differentials are intended to permit large families to have access to a larger range of units to partially offset the difficulties they have finding units.

As a policy matter, it may not always be appropriate to use the exact local market intervals. For example, rent levels for efficiency units can be significantly above the one-bedroom level in markets with a very limited efficiency supply comprised largely of luxury units. Quality differences are likely to explain at least part of the reason for higher rents for smaller units and lower rents for larger units in a given market area. Establishing FMRs for smaller bedroom size units that are higher than the next larger bedroom size would create a credibility and equity problem.

Definition of FMR Areas: FMR areas are defined as metropolitan areas and as nonmetropolitan counties. For metropolitan FMR areas, the Department uses the OMB metropolitan area definitions of Metropolitan Statistical Areas (MSAs) and Primary Metropolitan Statistical Areas (PMSAs). It has been suggested at times that FMRs be established on a more localized than metropolitan area basis has been considered by HUD in the past, but this policy has not been adopted for two reasons. The first is that the legislative history of the program makes clear that FMRs were intended to be set on a "market area" basis, that is, geographic areas within which housing units are in competition. HUD considers metropolitan areas as defined by OMB to be the best and most consistent definitions of housing markets because they are based on precise criteria dealing with population, employment and commuting patterns. Developing FMRs for parts of metropolitan areas is inconsistent with this policy Furthermore, it is not feasible for most areas because of data limitations.

The second reason for not making FMRs more localized relates to program objectives. Highly localized FMRs (e.g., township level or center city/suburb distinctions) would result in inequitable treatment of program participants. If the Department were to raise FMRs in the high rent areas, for example, they would have to be lowered in the low income distressed areas of the FMR area. The program goal is to provide the broadest choice possible of housing opportunities for the most needy families. A single FMR standard for entire housing market areas is believed to be the best way to achieve this goal.

Data Sources: In developing the FMR estimates, the Department uses the most accurate and current data available. FMRs are based on decennial Census data, AHS data, and CPI data. For all areas, FMRs are rebenchmarked every 10 years when the results of the Census become available. For the metropolitan areas with AHS data, the FMRs are rebenchmarked every four years on the basis of the results of these surveys. The AHS surveys are conducted by the Bureau of the Census and have been designed to replicate the standards of accuracy of the decennial Census of Housing. All FMRs are updated annually with the relevant CPI data that is available for 72 individual metropolitan areas and the four Census Regions.

Accuracy: Two methods are used to assure that rent estimates are as accurate as possible. First, initial estimates are based on the best available data at the point they are estimated. Second, use of a public comment process serves as a basis for re-examining and improving estimates which are suspect. Evaluations of the FMRs for the larger market areas suggest that they are within an acceptable range of accuracy. The best estimates are those that have been developed for the areas that have been surveyed by the AHS since the 1980 Census. These areas, in total, comprise over half the rental housing inventory in the United States.

Accuracy tests were made of the FMRs when they were rebenchmarked with the 1980 Census data. At that time, the FMRs based on 1970 Census data were compared with the FMRs based on 1980 Census data. These comparisons were worst case estimates in that they captured the cumulative errors for the entire decade. The results showed that about 60 percent of the FMR areas had FMRs that were within plus or minus 10 percent. The areas outside this range, typically, where lightly populated nonmetropolitan counties.

Comparisons also are made of the national FMR average with the national AHS-based FMR estimates as they become available. The 1987 national AHS revealed that the two estimates were differed by about five percent. The weighted average U.S. FMR for a two-bedroom unit was $448 and the AHS-based estimate was $425. Previous comparisons have generally been within a close range. The significance of the comparison is that, on balance, the Department is spending Section 8 funds in compliance with the ceiling rent standard.

Modification and Exceptions: The FMR estimation procedures used are known to work reasonably well for most areas. Estimates for nonmetropolitan counties and for metropolitan areas not covered by AHS or CPI surveys pose the greatest problems. The longer that Census Regional CPI figures are used rather than area-specific data to update FMR estimates, the greater the likelihood that FMR estimates will be higher or lower than intended. This is because changes in these housing market areas can occur relatively quickly. In addition, housing markets are a composite of different submarkets with varying unit characteristics and rent structures. To permit successful program operations under these conditions, the current Section 8 regulations provide three methods for correcting situations where the FMRs are too low to meet program objectives:

- A public comment/appeals process, whereby localities may submit data which documents that published FMRs for one or more bedroom sizes need to be revised. Such changes are referred to as modifications of the FMR standards.

- Local discretion to increase FMRs by up to 10 percent for up to 20 percent of authorized units, and by up to 10 percent for a higher percentage of units when approved by HUD. Such increases are referred to as exceptions to the published FMR standards.

- HUD may approve a request from a PHA to increase FMRs by up to 20 percent above published FMRs for selected parts of MSAs or non-metropolitan counties, but such increases may not apply to more than 50 percent of the housing market area. Such increases are also referred to as exceptions.

Senator **Graham**. Thank you, Mr. Weicher.

Mr. Logue.

STATEMENT OF JAMES LOGUE, DEPUTY ASSISTANT SECRETARY FOR MULTIFAMILY HOUSING PROGRAMS, HUD, WASHINGTON, DC

Mr. **Logue**. Mr. Chairman, it is a pleasure to be here. Before I get into my statement on Mod Rehab, I have been requested by Secretary Kemp and with your permission, I would like to submit a statement regarding a very important court decision in the 9th Circuit Court of Appeals relative to the Rainier View rent comparability case that we consider at the Department to be very critical to our ability to have funding available for our housing programs in the future.

It is a ruling that could cost the Department anywhere from $600 million to $1 billion. Right away. And if it is applied nationally, anywhere from $1 billion to $1.5 billion, on a national level over the next 10 years.

So, with your permission, I would submit that for you today.

Senator **Graham**. Excuse me, sir. I am very interested in that. Is that relevant to the issues that we are going to be discussing?

Mr. **Logue**. It is relevant to the issue of rent comparability. We have basically through a court decision been unable to apply rent comparability in the 9th Circuit Court area, which is the Northwest. And it has an impact and the Secretary asked that I do this, and I believe members of the committee staff were advised that we would be submitting that for the record today.

Senator **Graham**. Just for clarification, would you define rent comparability as it is at issue within this litigation?

DEFINITION OF RENT COMPARABILITY

Mr. **Logue**. The issue specifically in this litigation is that for section 8 projects the Department has, for future rent increases, the ability to, in our contracts, we believe, to set rents, rent increases based on one of two factors—an automatic adjustment factor, which is basically a straight percentage of the rents, or if that presents a rent that is in excess of the fair market rents in that area, a rent comparability test that would, in effect, limit unwarranted windfalls to project owners in these particular projects that we would othewise have to pay out.

We have been in litigation on this issue for a number of years, and we believe that the court's position on this is a misreading of our contract and of our statutory authority to apply this factor.

And at this point, because of the numbers involved and the potential for this costing us funds that would otherwise go to other programs, we are seeking legislative assistance in remedying this problem.

Senator **Graham**. And does the material that you have supplied the committee include the legislative remedy that you would like?

Mr. **Logue**. Yes.

Senator **Graham**. I wish we could pursue that issue further. But since at least I am not prepared to do so, I would suggest that maybe we might hold that for a subsequent hearing when we would be in a position to pursue it from a foundation of greater knowledge, or less ignorance.

Mr. **Logue**. I understand.

[The document referred to follows:]

Supplemental Statement on Rent Comparbility

STATEMENT OF JIM LOGUE DEPUTY ASSISTANT SECRETARY FOR MULTIFAMILY

Mr. Chairman, a recent decision in a case before the Ninth Circuit Court of Appeals has disapproved the way HUD sets annual rental increases for project owners in the Section 8 rental assistance program. The decision has set the stage for a considerable reduction in the future funding that may be available for new rental assistance payments contracts for families, and an increase in the amount needed to fund retroactive increases in rents paid years ago.

The decision is in Rainier View Associates v. U.S., 848 F 2d 988 (9th Cir. 1988) cert. denied, ________ U.S. _____, 109 S. Ct. 2065 (1989). The Ninth Circuit held that HUD had misconstrued section 8(c)(2)(C) of the United States Housing Act of 1937. Under it, HUD has since 1981 used comparability studies as a means of implementing the statutory requirement that there are no "material differences" between rents of assisted units, and rents of comparable unassisted unit.

HUD has estimated that if this ruling were applied to all affected section 8 projects within the Ninth Circuit's jurisdiction alone, the potential financial exposure for retroactive payments might amount to as much as $150 million. Moreover, HUD estimates that if the Ninth Circuit case were applied nationwide, the Government's potential costs would reach $600 million to $1 billion for retroactive payments; and if the rationale of the case is applied in the future, it would cost an additional $1 billion to $1.5 billion over the next 10 years.

The Ninth Circuit interpretation of section 8(c)(2)(C) is puzzling since the statutory language seems clearly contrary to the holding in the case. It is also inconsistent with HUD's practice under the statute since 1981, when the first comparability study was done. Furthermore, Congress recently reviewed section 8(c)(2)(C), and in section 142(c)(2)(B) of the Housing and Community Development Act of 1987 (Public Law 100-242) elaborated and made more specific the comparability study requirements. HUD's construction of section 8(c)(2)(C) also has been a predicate for the amounts appropriated for the Section 8 program.

Mr. Chairman, our review of projects in the Ninth Circuit shows that the payments to be made to Section 8 project owners will in some instances triple and quadruple the amount of residual funds maintained in the projects' accounts. The substantial balances in these residual receipt accounts indicate that the projects are operating successfully without need for arbitrary increases in rents or subsidy payments. To make these payments to project owners for no additional services performed or expenses incurred is unreasonable and ignores the scarcity of critical housing subsidy funds available to serve poor people.

Mr. Chairman, as the Committee continues its review of waste and abuse of HUD programs the Department strongly urges prompt legislative action to clarify Section 8(c)(2)(C) and prevent these windfall payments from being made.

Mr. LOGUE. I will summarize my written statement and ask that my entire statement be put in the record.

We were asked to discuss the problem, how it could be corrected with emphasis on the rent calculation process.

Secretary Kemp remains steadfast in resolving the problems in the Mod Rehab Program.

He responded in the HUD inspector general's 1986 audit report of the program. We can assure you that, under Secretary Kemp's leadership, we will administer programs not only ethically and efficiently but also competitively and consistent with the statutory requirements of the program.

When the Department designed the Mod Rehab Program in 1978, it was with the recognition that there was a major segment of the housing stock which was not being addressed by other HUD programs.

To target that stock, the Department designed a program that would offer financial incentives to the small owner and which would be administered by public housing agencies, so that technical assistance to owners would be available at the local level.

RENT CALCULATION PROCESS

The Mod Rehab Program rent calculation process was designed with the basic program objective in mind. The PHA is required to determine the rehabilitation necessary to bring the unit to a standard condition. These rehabilitation costs are reimbursed through the section 8 rents.

As Mr. Weicher mentioned in his testimony, it is important to stress that while the Mod Rehab Program fair market rent is a ceiling on the section 8 contract rents, the program rent for a particular project is to be calculated on a cost based procedure.

The Mod Rehab Program requires that a unit need at least $1,000 worth of rehab. No maximum rehabilitation amount was ever established for the program.

However, the original design of the program will generally limit rehabilitation to a modest level if it is followed.

Projects with costs that exceed modest amounts of rehab generally are unfeasible under the Mod Rehab Program. The recent IG audit reports bear this out. In most cases, where rehab was accomplished under mod rehab, one or more of the rent calculation requirements were not followed.

What did go wrong with the program?

First, I think it is important that the evolution of the program in the context of other assisted housing programs be considered; although the Mod Rehab Program was originally designed to provide assistance to owners of small projects to do moderate amounts of rehabilitation, during the time period we are talking about, the programs which had provided assistance to large developers with major rehab projects were terminated.

Some of these developers look to continue their activities through the Mod Rehab Program. At the same time, the Department's fair share requirements were suspended by Congress essentially because the number of units appropriated were perceived to be too small to allocate on a formula or fair share basis.

As a consequence, decisions on funding were made in HUD headquarters as opposed to the field or through a fair share process.

The Office of the Inspector General identifies the causes of the abuses in the program in recent years, and the Office of Housing and the Department acknowledged that the IG findings were basically accurate.

These can be outlined briefly by the following:

INSUFFICIENT ACCOUNTABILITY

There was insufficient accountability in the funding decisions made by headquarters. Headquarters program staff was not given adequate resources to continue to provide the needed program guidance material, training, and monitoring.

HUD field offices were not given adequate staff and indications of priority to monitor implementation of the program.

The inspector general reported that headquarters selection processes contributed to a widespread perception that the Mod Rehab Program was to be guided by unwritten sets of rules, and that the projects selected were to be made to work.

For similar reasons, PHA's disregarded the guidelines and regulations.

What do we do to fix the problem?

One key premise I would hope to convince you of is that the Mod Rehab Program design was not seriously flawed. If, as the OIG report acknowledges, basic rules had been followed, the abuses would not have occurred.

What have we done so far?

CORRECTIVE STEPS AT HUD

We have imposed a freeze on pending Mod Rehab Projects and sent special teams to review the key areas of project selection and rent calculations. We are committed to reviewing all large Mod Rehab Projects to ensure that Mod Rehab rents have been calculated correctly. And to correct, and if necessary, reduce rents where appropriate.

We have cancelled funding to PHA's wherever legally possible and are conducting a better process to determine which PHA's should be receiving funding this year.

We hope to improve guidance and provide monitoring and training for the field staff and for PHA's administering the program.

We are exploring ways to develop the process that will allow the Department to account for the application of tax credit proceeds in determining the rents supporting a particular project.

And we will consider and, hopefully, work together with Congress in defining and redefining the program objectives of the Mod Rehab Programs, if, in fact, we have funding.

I will at this point conclude my overview and I will be happy to answer any questions that you might have.

[The complete prepared statement of James Logue follows:]

STATEMENT OF JIM LOGUE DEPUTY ASSISTANT SECRETARY FOR MULTIFAMILY HOUSING

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

SEPTEMBER 18, 1989

Mr. Chairman, and members of the Committee. I appreciate the opportunity to appear before you to discuss the workings of the Section 8 Moderate Rehabilitation program, how it was abused, and how we think it can be corrected with particular focus on the rent calculation process for units subsidized under the program.

First, let me say that Secretary Kemp remains steadfast in his commitment to resolve the problems surrounding the Section 8 Moderate Rehabilitation program. His first reform action was to respond immediately to the short-conings outlined in the HUD Inspector General's April 26, 1989 audit report of the program. We can assure you that under Secretary Kemp's leadership, we will administer programs not only ethically and efficiently, but also competitively and consistent with statutory requirements, for their legitimate purpose.

When the Department designed the Moderate Rehabilitation Program in 1978, it was with the recognition that there was a major segment of the housing stock which wasn't being addressed by other HUD programs. Data available at the time indicated that 2.7 million rental units had deficiencies requiring a moderate amount of upgrading (estimated at $3,000 - $8,000 per unit), that 85% of those units were in buildings of fewer than 20 units, and that 85% of those units were occupied by low income tenants who were eligible under the Section 8 income standards. To target that stock, the Department designed a program which would offer financial incentives to the "small" owner, and which would be administered by Public Housing Agencies (PHAs) so that technical assistance to owners would be available at the the local level and the "red tape" of federal requirements would be limited. PHAs' with experience in administering the Certificate Program would be useful in identifying and dealing with local landlords who could benefit from participation in the Moderate Rehab Program. PHAs were given the responsibility of selecting properties for assistance, based on locally-designed public notice and competitive selection procedures, which were to be reviewed by HUD Field Offices to assure compliance with regulatory requirements. PHAs could target the Moderate Rehab Program to serve local priorities, such as neighborhood revitalization or deconcentration of assisted housing by rehabilitating scattered duplex or single family units available for rent.

The Moderate Rehabilitation Program rent calculation process was designed with the basic program objectives in mind. The PHA is required to determine the rehabilitation necessary to bring the unit to a standard condition; these rehabilitation costs are reimbursed through the Section 8 rents. HUD has issued guidelines for determining eligible rehabilitation activities and costs. To determine the Section 8 contract rent, the cost of amortizing a loan for the eligible rehabilitation work is added to the basic costs of owning, operating, and managing the property. The costs of owning and operating the property can be established by the PHA by following a HUD formula which includes current or projected costs for items such as property debt service, taxes, insurance, utilities, reserve for replacement, management and maintenance, and a limited return on equity in the property. As a simpler alternative, the owner's current rent can be used.

Section 8 contract rents are calculated by the PHA prior to the beginning of rehabilitation, and the owner executes a legal document agreeing that these rents will be acceptable. Initial contract rents cannot exceed the Moderate Rehabilitation Fair Market rents in effect at the time the PHA and owner execute the document prior to rehabilitation. (The MR FMR is by definition, 20% higher than the FMR published for the Existing Housing Certificate program.) The owner will not receive housing assistance payments (which, combined with the tenant's share of the rent, will equal the contract rent) until rehabilitation has been completed to the PHA's satisfaction. I want to stress that while the Mod Rehab program Fair Market Rent is a ceiling on the Section 8 Contract rents, the program rent is calculated on a cost-based procedure.

The Moderate Rehabilitation Program requires that a unit need at least $1,000 worth of rehabilitation to bring it to a standard condition. No maximum rehabilitation amount has ever been established for the Program; however, the original design of the Program, with restrictions on eligible rehabilitation items and a rent cap of 20% above the Section 8 Certificate Program limits, will generally limit rehabilitation to a modest level, if followed. Projects with costs that exceed modest amounts of rehabilitation (i.e., requiring substantial or gut rehab) generally are not feasible under the MRP. The recent IG audit reports bear this out; in most cases where gut rehab was accomplished under the Moderate Rehabilitation Program, one or more of the rent calculation requirements (FMRs, rent calculation procedures, eligible rehabilitation items) were not followed.

We were also asked to identify what went wrong with the program design, what were the "soft points" in the Moderate Rehabilitation Program which were easy to exploit, and the areas that allowed abuse of the program.

First, I think we have to put the evolution of the program in the context of other assisted housing programs. Although the MRP was, as I've explained, originally designed to provide assistance to owners of small projects (i.e., 20 units or fewer) to do moderate amounts of rehabilitation, during the time period that we're talking about (1984- and on), the programs which had provided assistance to large developers with major rehabilitation projects were terminated. Some of those developers looked to continue their activites in the MRP.

At the same time, the Dept's fair-share requirements -- a system of allocating MRP funds to HUD Field Offices, which then determined PHAs to be funded on the basis of unmet housing needs and PHA capacity -- were suspended by Congress (essentially because the number of units appropriated was perceived to be too small to allocate on a formula, "fair share" basis). As a consequence, decisions on funding were made in HUD Headquarters.

I want to underline one point. Absent other project-based programs which responded to the interests of major developers, it is understandable that they would attempt to utilize the MR program for purposes not intended in the program design. The pressures to fit a fat square peg in a small round hole contributed to the abuses in the program, but are not a function of the Moderate Rehab program design. Data which we have about the operation of the program in its early years, which I understand will be supported by other panelists who will testify today, show that the program was achieving the levels of rehabilitation and improvement of the housing stock for which it was intended.

The OIG report identifies the causes of the problems in the program in recent years and the Office of Housing has acknowledged that the OIG findings were basically accurate. Other problems flowed from these basic factors:

- There was insufficient accountability in the funding decisions made by Headquarters. There was no demonstration that funding was provided to those PHAs with relatively greater housing needs or to those with a demonstrated capacity to administer the program in compliance with the rules.

- Headquarters program staff was not given adequate resources -- and by that I mean staff and information systems -- to continue to provide needed program guidance material, training and monitoring.

- HUD Field Offices were not given adequate staff and indications of priority to monitor implementation of the program. OIG reported that the Headquarters selection process contributed to a widespread perception that the MRP program was to be guided by an unwritten set of rules, that the projects selected were to be made to work. Field Office staff often responded to what they perceived to be their Superiors' agenda, so there wasn't management pressure to enforce the MRP regulations.

- For similar reasons, PHAs disregarded the regulations.

So, how do we fix it?

One key premise I hope to convince you of is that the MRP program design was not seriously flawed. As the OIG report acknowledges, if the basic regulations had been followed, the program abuses you're concerned about wouldn't have occurred.

Another is that Secretary Kemp has been clear - in words and deeds - that we are going to run the program consistent with the regulations.

We've already taken a number of corrective actions, and intend to take more:

- We imposed a freeze on pending MRP projects, and sent special teams to review the key areas of project selection and rent calculations. PHAs are not allowed to proceed with commitments to owners unless we're assured that the regulations have been followed.

- We've committed to reviewing all large MR projects to assure that MRP rents have been calculated correctly, and to correct (i.e., reduce) rents when appropriate.

- We've cancelled funding to PHAs whenever legally possible, and are conducting a competitive process - based on relative need and PHA capacity - to determine which PHAs should be receiving funding this year.

- We hope to improve guidance and provide monitoring and training for Field staff and for PHAs administering the program.

- We are exploring ways to develop a process that will allow the Department to account for the application of tax credit proceeds in determining the rents for a particular project.

- Depending on whether there is a future for the MRP, we will reconsider the program objectives and design.

Secretary Kemp has articulated two principles which are governing the Dept's current activities. The first is that he will not tolerate any abuse of the current program regulations, and expects all employees of the Department to assure that the rules are followed and that this and other programs are administered in compliance with the rules, with integrity. Second: any redesign of the program will be in the interests of the clientele we are in the business of serving, with the mission of fulfilling the legislative mandate of providing decent, safe and sanitary housing.

I know there is Committee interest in the phenomenon of "exception rents" in the Moderate Rehabilitation Program. HUD's regulations for the Section 8 Moderate Rehabilitation Program permit, in limited circumstances, exception rents which can be higher than normal Moderate Rehabilitation Program Rents. As John Weicher has explained, there is a geographic exception designed to allow these programs to be feasible in those communities within a FMR area which have higher than average market rents. When HUD determines that rents for standard units suitable for the Existing Housing Certificate program are more than 10% higher than the published Existing FMRs, exception rents under the Moderate Rehabilitation Program can be up to 10% higher than normal rentals (i.e., 132% of the Section 8 Existing Housing Fair Market Rents). A second regulatory provision permits exception rents--which can be up to 20% higher than normal Moderate Rehabilitation rents (i.e., 144% of the Section 8 Existing Housing FMRs) -- when during rehabilitation work items are discovered which could not reasonably have been anticipated, were not in the work write up, and are required by the PHA. Separately or in combination, these exception rents cannot exceed 20% of the Mod Rehab FMR (144% of the Existing Certificate program FMR).

This exception is often referred to as the one to cover what is found "behind the walls" after rehabilitation has started. HUD field offices may authorize these two exception rents in accordance with the regulations. I've provided a chart which helps illustrate this policy on exception rents:

	% of MRP/FMR**	% of EHP/FMR*
MOD REHAB	100%	120%
MOD REHAB EXCEPTION RENTS		
Geographic exception (granted for Existing Program)	110%	132%
"Behind the Walls" exception	120%	144%

*EXISTING HOUSING PROGRAM FMR: Published in Federal Register

**MODERATE REHAB PROGRAM FMR: 120% of Existing Housing Program FMR

Some projects may, therefore, have received exception rents authorized under these two regulations. Requests for exception rents which do not meet the two regulatory criteria could be approved only if a waiver of those constraints were granted by the Assistant Secretary for Housing. I understand that there are allegations that some projects were granted exception rents without meeting the tests required by the regulations, and without obtaining waivers of the regulations. We will review this as part of our commitment to review contract rents on all of the larger projects by our Field staff auditing teams.

In my statement, I have only been able to provide a general description of areas in the program that I understand are of interest to this committee. I am, of course, prepared to deal in more detail with any questions the committee may have.

Senator **Graham**. Thank you. I must say that I find the prescriptions that you suggest, beginning on page 6, to be woefully inadequate to the scale of the problem as it has been presented to this committee.

You state in one of your points that you are proposing to explore ways to develop a process that will allow the Department to account for the application of tax credit proceeds in determining the rents for a particular project.

We have heard repeatedly that it is this layering on of benefit after benefit, of which tax credits are clearly one suggested by our previous witness, that tax-free financing is another, the way in which coinsurance has been utilized is a third, and so forth.

I find it rather timid to say that you're only exploring ways to adjust the process for tax credits.

Could you explain?

Mr. **Logue**. The exploring aspect relates more to the process than the concept. Administratively as of the time I came to the Department, which was 3½ months ago, directed that any program funding decisions, whether it be in Mod Rehab or in any other programs, because Mod Rehab is not the only program that funding can be provided, for projects that may be eligible for the low-income tax credit, that we must develop a process to determine the application of tax credit proceeds to any program that we are funding. The commitment is to assure that our rent structures reflect only an appropriate level of tax credit proceeds going into the project—that is, to prevent unconscionable or unwarranted windfalls is a difficult, technical process. And it is a technical process that I must tell you has not been completely worked out in Mod Rehab or in other areas.

However, we will not be making any funding decisions henceforth without considering the application of tax credit proceeds to the programs that we would fund.

Senator **Graham**. Are you also applying that evaluation to other stacked benefits?

Mr. **Logue**. To the level that we can. There is a significant problem in trying to determine exactly what other benefits go to programs where we may be providing assistance, a training and resource and information-gathering problem.

Senator **Graham**. Why can't you ask the applicant to list any other sources of State, Federal or local benefits that are being derived so that you will be aware of those and can have that information taken into account?

Mr. **Logue**. That is exactly what we will be doing. But it is a difficult process, but that is exactly what we will do.

Senator **Graham**. I would like to come back to the basic question of how you calculate fair market rents.

When I heard the term fair market rents, I think of a process that goes into a neighborhood, determines what rents are being paid for units similar to those that I am proposing to rent and use that as a marketplace guide to the types of rents that would be appropriate for me to either rent as a landlord or pay as a tenant.

We had testimony at our previous meeting from a developer in California that that was in fact a process, that his nonprofit firms, which, incidentally, do not participate in the Mod Rehab Program—utilized—and that it was a very simple standard and straightforward process.

Why doesn't HUD use that method of arriving at fair market rents as opposed to what appears to be a very complex and convoluted—and I'm going to suggest in some further questions—ineffective program in arriving at fair market rents.

FAIR MARKET RENTS

Mr. **Weicher**. The procedure you have described, Senator, is basically the procedure that was used in the section 8 New Construction Program and substantial rehabilitation program where the rent levels, the fair market rents were based on comparable projects. In the existing housing programs, the fair market rents are set based on the entire available stock of existing housing rather than trying to go and identify specific projects and specific neighborhoods that are similar to each of the units that people might want to choose to live in.

We have over one million units in the voucher and certificate programs combined, and the fair market rents provide a ceiling up to which we will provide subsidies within a particular market, within a particular country, or metropolitan area.

Senator **Graham**. Why would you use a different process of arriving at fair market rents than the Mod Rehab Program that you indicate had been used in other section 8 programs?

Mr. **Weicher**. Because the Mod Rehab Program was an attempt to encourage rehabilitation of units that might not meet these program standards.

And additional subsidy above the fair market rent for existing units was offered in the program as it was designed in 1978, as it was established in law.

Senator **Graham**. Here's what the law says:

> The Secretary may, in carrying out the preceding sentence, establish a maximum monthly rent for units upgraded pursuant to this paragraph which exceed the fair market rental by not more than 20 percent.

And it goes on.

But that section starts with the, "fair market rental," and then it can be exceeded by up to 20 percent.

And my question is why don't you use the same method of arriving at fair market rental in Mod Rehab that you use in the other programs?

And then from that base make a judgment as to whether it is appropriate to utilize the statutory authority to go above 20 percent.

Mr. **Weicher**. We do establish the basic fair market rent in the Mod Rehab Program as a direct 20 percent above the fair market rent in the voucher and certificate program as stated in the law as you have just read it.

Exceptions above that, which are also authorized in the law, are calculated on a different basis than the Mod Rehab Program because of the point that as you get into the construction, the actual rehabilitation work, you may discover that you have additional costs beyond those, the so-called behind the walls costs.

And if that happens, then additional 20 percent, up to an additional 20 percent, can be made available.

Senator GRAHAM. You have leap-frogged me.

Mr. WEICHER. I'm sorry.

Senator GRAHAM. I'm staying at the front end of the sentence, which, "exceeds the fair market rental by no more than".

Why don't you arrive at the base line what the fair market rental for these units will be, before you get into the consideration of additives by the same method which you used for other section 8, which you indicated was the process analogous to that that I indicated was utilized in the private sector?

Mr. WEICHER. We basically start with the rent of units that are currently being rented in the private market by lower income people. And that becomes the fair market rent in the voucher and certificate program, and that becomes the basis on which the maximum Mod Rehab rent can then be 20 percent above the fair market rent by law.

The contract rents for each project will be established based on the costs of that actual rehabilitation and they will not automatically be 20 percent above the voucher and certificate fair market rent.

There was some confusion I think in the previous testimony about the contract rent and the fair market rent. The fair market rent is established by this procedure and it may be, say, $600 per month. The contract rent would then be established under that ceiling depending on the actual costs of the rehabilitation.

Senator GRAHAM. Well, I hope we are making some progress in terms of understanding the terms and the sematics here.

Let me see if we can flesh that out by asking a couple of specific questions.

Do I understand that the way in which you establish what is the market for rentals is on essentially a community-wide basis?

You refer in your testimony to the number of metropolitan or nonmetropolitan areas that were subject to a rental evaluation.

Is that correct?

Mr. WEICHER. That's correct.

Senator GRAHAM. Would the District of Columbia be one of those?

Mr. WEICHER. Yes.

Senator GRAHAM. Would that mean that you would have the same assumption of fair market rental throughout the District of Columbia?

Mr. WEICHER. The fair market rent is calculated for the entire metropolitan area, which would include Arlington County and Alexandria. It would include Prince George's and Montgomery County. It would include Fairfax County and the city of Fairfax. And I believe would include Prince William County, although I'm not sure of that.

Senator GRAHAM. What is the rationale for arriving at fair market rental on such a large and diverse geographic area?

Mr. WEICHER. The fair market rents are established for metropolitan areas as identified by the Census Bureau and the Office of Management and Budget. And the basic rationale for saying that all of this is a metropolitan area is that this is basically a single labor market in which people can commute from all over this market into the center of the city, and can commute from one country to another. It is basically an overall housing market; although there are submarkets within it. It is a media market. This is the community in which we live. In the largest metropolitan areas, as New York, Washington, Chicago, they will cover substantial areas and a large number of people.

Senator **GRAHAM**. Are you suggesting that the position of the Department is that the same rent situation exists between Georgetown and the inner-city of the District of Columbia?

Mr. **WEICHER**. No, not at all. We will supply a subsidy up to the 45th percentile of all existing housing for anyone within that overall market. And they can take the subsidy that they are offered and choose to rent anything within that market area that rents for the 45th percentile or less.

In the case of the certificate programs or in the case of the voucher program, they can get a subsidy up to that amount, that 45th percentile. And if they choose, spend more of their own income to rent something that is more expensive.

We make no effort to say that Georgetown has the same rent schedule as Anacostia or as the city of Fairfax. We simply say that in that overall market we will provide the same level of subsidy for anyone living in that area, in that overall market, to live anywhere within that overall market that they choose.

Senator **GRAHAM**. I want to pursue this, but my time for this round is up.

Senator Bryan.

Senator **BRYAN**. Thank you very much, Mr. Chairman.

Maybe I can help you because I was not tracking with that either.

Mr. Weicher, you have described this large metropolitan area. You're talking in terms of 45th percentile. But in calculating what the base line is, if you use that entire area as one composite, it strikes me that the premise you proceed from is greatly inflated with respect to certain areas.

We all would acknowledge that within that metropolitan area there are so-called high rent areas and low rent areas. How do you amalgamate all of that together? That just doesn't make any sense to me.

Mr. **WEICHER**. Senator, if you were in the rental housing market in Washington, in the Washington metropolitan area, you can choose, if you have the income, you can choose to spend a very large amount of money to rent something in Georgetown or a more moderate amount of money to rent in other parts of the Washington metropolitan area.

And there are a few places in the area where you can rent for a very small amount.

The basic idea is that this same level of subsidy would be provided to anyone living in the overall Washington market area. And they can take that amount of subsidy and choose to find any place in the overall Washington area that they can afford within the amount of subsidy that we are prepared to provide.

That is not likely to be in Georgetown. But, if we were to establish a separate high fair market rent in Georgetown to allow a handful of poor people to live in Georgetown with a Federal subsidy, we would then be establishing a separate, lower fair market rent in other areas where more poor people would be living.

If you calculate a separate rent for each neighborhood, then you are saying to someone who chooses to live in a very expensive neighborhood we will give them a large subsidy to do that.

And someone who is not able to find a unit on that basis because there won't be very many of them, we will give you a much smaller subsidy to live somewhere else; and, therefore, you will not be able to live as well.

We believe that it is appropriate to treat each metropolitan areas as it is indeed as basically an overall housing market within which there are some neighborhoods that have very good housing and some neighborhoods not so good, and let anyone who has a subsidy live anywhere within that market that they can find and that they can afford.

Senator BRYAN. Do you include all rental stock?

Mr. WEICHER. All rental stock except substandard units and except recently built units. We exclude units built within the last 2 years.

Senator BRYAN. So, in developing that standard from which the percentile that you provide the subsidy for, you would include the most expensive rental housing that would be available, say, in the District of Columbia or some of the more affluent suburbs?

Mr. WEICHER. Yes, but then you would take the 45th percentile of that rent distribution, which nationally works out to about $500. Since we got into Washington, I cannot give you the specific number for Washington. But it would be nationally $500. And that would be calculated on the basis of a distribution which would include a few units in the $2,000 perhaps range. And include a lot more units that were right around that $500 figure.

Senator BRYAN. I am not in a position to debate how the math works out. I must say I think the American taxpayer is shocked to hear that in terms of what this subsidy ought to be and we certainly ought to provide affordable housing for people, and I support the concept of housing subsidies, that you incorporate within the overall calculation some of the most expensive rental property in America. Somehow that just strikes me as reaching a wrong conclusion.

But setting that aside for a moment, let me get more specific.

You heard the testimony previously this morning from Mr. Adams, and he indicates in effect—I think these are my words, but I think it is a fair characterization—that this process became perverted and corrupted when it was transferred from a fair share concept to a project specific discretionary allocation.

Is the Department making a recommendation or have you returned to the fair share allocation concept?

Mr. LOGUE. Let me respond to that.

Senator BRYAN. Sure.

RETURN TO FAIR SHARE ALLOCATION

Mr. LOGUE. Right now we have in effect for the Mod Rehab Program that we have funding for in this fiscal year—essentially, it has gone back to a fair share distribution of the units based on relative need in the area and the capacity of the public housing agency to administer the program effectively in accordance with regulations.

Senator BRYAN. I am pleased to hear that, Mr. Logue. In effect, the Secretary, at least by implication, acknowledges that the fair share is the proper policy to pursue?

Mr. LOGUE. No question about that.

Senator BRYAN. And I would presume that that would be implemented by some kind of a regulation so that we don't drift from that concept?

Mr. LOGUE. I believe if it is appropriate to do it by regulatory processes that is how we will do it.

Senator GRAHAM. Excuse me, if I could interrupt.

Senator BRYAN. Sure, you bet.

Senator GRAHAM. As I understand, when fair share was in place it was in place through the appropriations process and it was an annual provision inserted in the HUD appropriations bill. If the Secretary feels that it is appropriate to restore fair share and if the Secretary has any questions as to whether he has current statutory authority to utilize that, that HUD appropriations bill is going to be before the Senate maybe as early as midweek, and I would urge your review of those questions, and if you feel that some provision is called for in the appropriations bill, these Senators would be very interested in being advocates for that.

Mr. LOGUE. My understanding is that it is not necessarily required, but——

Senator GRAHAM. I am going to—excuse me for interrupting in your time.

Senator BRYAN. That is all right. Go ahead.

Senator GRAHAM. This issue has urgency. Unless we hear from you I assume that two things have happened. One, you have exercised your judgment to restore fair share and, two, you have concluded that you don't need any specific congressional authority to do so.

If either of those two assumptions is wrong, I am placing the burden on you to communicate that back to us prior to the commencement of consideration of the HUD appropriations bill.

Is that a fair standard for fair share, Senator?

Senator BRYAN. Thank you very much, Mr. Chairman, and further, we are operating on the premise now that fair share is in fact being implemented.

Am I correct, Mr. LOGUE?

I know you are getting notes from some of your staff members, and I will give you time to look at that before you respond to my question, but I want to be real sure that right now today, not next week or the day thereafter, that you are actually implementing this Mod Rehab Program with the funds that you have available on a fair share allocation basis?

Mr. LOGUE. Yes, that is correct, and to clarify the point, this, by the way, is Larry Goldberg, my Director of the Office of Assisted Housing. The appropriations bill took it out, took the fair share out, and if appropriations doesn't specifically delete it each year, it applies.

So it appears to me to be an affirmative action has to be taken in order to delete the fair sharing for Mod Rehab.

Senator BRYAN. Let me hear that again, Mr. Logue. Maybe Senator Graham was following that better than I, but you are indicating that it was originally in the appropriations bill but was deleted, or did I misunderstand?

Mr. LOGUE. That is my understanding. The appropriations bill incorporated fair sharing and that affirmative action to delete it was what caused the previous ability not to fair share.

Senator BRYAN. That is historical. I think that is true.

My question—and I don't want to get into an area that Senator Graham may want to pursue, but I am interested and I think he is, too, on the appropriations bill that is being processed currently.

Is there any question in your mind that you have the authority to continue the fair share allocation, or do you believe that some affirmative action needs to be taken by the Congress to give you that authority?

Mr. LOGUE. My understanding is that we have the authority to implement fair share.

Senator BRYAN. And that having examined that appropriations bill there is noting contained therein that in any way limits or restricts—and I see your capable staff member nodding, and we will take nodding as affirmative—and for the record you are convinced, having examined the record, that this appropriations bill permits you to continue with the fair share process that you have been pursuing in the 3½ months, I think, that you told us you have been on board, Mr. Logue?

Mr. LOGUE. Based on my staff's advice, yes.

Senator BRYAN. I think that is an appropriate disclaimer.

Let me ask you a couple of other questions, and then I will yield my time back to Senator Graham.

We have had some testimony that even in those instances where there has been an objection to the fair market rent, that in the public hearing process there has been an objection that really no action was taken by HUD for a long period of time, and the next time the public housing authority looked at the situation that project was actually under construction, being built.

My specific question, are you examining those projects that may be in the pipeline now and specifically focusing on areas where there were objections to the fair market rent that was incorporated into the project and to the extent that you can either disallow or force the reevaluation of that fair market rent that was incorporated into the project plan as it moved forward?

Mr. LOGUE. We are doing more than prospective. We have agreed and worked out with the inspector general to a plan of action that is in the process of beginning right now to review 300, plus or minus, moderate rehabilitation projects that have been funded since 1984 that will—we will be sending out auditing teams trained to review these projects in the field to assure that the rent calculation process was conducted in accordance with the regulations and to the extent that we find deficiencies or problems with that, we will take action, which can include a reduction of those rents if it is appropriate.

Senator **Bryan**. My time is running out, but let me just indicate that a number of us on this panel on both sides of the political aisle were pleased to see the appointment of Secretary Kemp. We think he brings the kind of energy level that is going to be needed to clean up this mess. I would hope that this agency would be very aggressive and very tenacious and not the least bit hesitant in recommending to the Congress those steps that need to be taken in terms of any statutory changes in these various programs that you administer, and I would hope that you would be equally aggressive in looking at any of the regulatory framework that you have to operate within and, where necessary—I know that there have been comments that there was a lack of resources and lack of personnel at the local level, at the regional level, and the national level.

Even assuming that that may be the case, I think that the problems are much more deeply rooted than that, and I would hope that you would focus, based upon the historic data that has been shared with us today and which you are very much aware of and live with every day, so that we can come up with a program that has the kind of credibility that it will need to receive the funding that we will have to provide at the congressional level and to enjoy public support.

I happen to think that these programs are essential, but I must say in talking with people there is a sense of cynicism that is pervasive in nature that no program of this magnitude seemingly can be managed with a sense of integrity. I reject that notion, but I understand how the public feels that way.

This is now on your watch, Mr. Logue. You have apparently the benefit of not having been part of the prior problem, and I would hope that you would be very, very aggressive, and I am sure that the Secretary, based upon his temperament, will give you latitude to show that aggressiveness in administering this program.

And I thank you, Mr. Chairman.

Senator **Graham**. Thank you, Senator.

I want to come back to understand how this fair market rent is calculated. Let me use a hypothetical. Assume we had a community in which for the same type of rental unit in the upper quartile the cost would be $1,000 a month, in the second quartile $800, and in the third quartile $600, and in the fourth quartile $400. Those would be the average costs of rental of a similar unit in those segments of the community.

As I understand it, you would set the community-wide base at the 45th percentile, which in my example would be somewhere between—would be slightly under $700 if $700 would be the 50th percentile. I am just trying to use a hypothetical so I can understand the situation.

Mr. **Weicher**. I think you may be starting from a different way of thinking about the rents than we actually use.

If—let's say that 25 percent of the units rent for $400 or less, another 25 percent rent for $400 to $600.

Senator **Graham**. What I am saying—and I don't want to get hung up in the hypothetical. I am just trying to use that so that I can ask some questions. We are assuming that you stratify this particular community into four levels. At the highest level the average rent in that highest 25 percent of the community for this particular type of unit is $1,000 a month. We would not take——

Mr. WEICHER. We would not calculate an average in any part of the distribution. We would rank all of the units from cheapest to most expensive, and we would say that along that distribution the 45th percentile up from the cheapest is where we make the cutoff. That would not depend on how far below that any cheap unit rented for, and it would not depend on how far above it any expensive unit rented for.

So if in the top quartile the average rent was $1,000 or the average rent was $10,000, it would not affect the 45th percentile because that would be based only on how many units are above it and how many units are below it.

Senator GRAHAM. Again, I don't want to spend our time with a hypothetical, but assumedly under my example if there were 1,000 apartments in this particular community you would have—500 of the apartments would be $700 or above and 500 of the apartments would be $700 or below?

Mr. WEICHER. Right.

Senator GRAHAM. You would come down somewhere below $700 and you would intersect the 45th percentile?

Mr. WEICHER. That is right. It would be a little less than $700, depending on the distribution below $700.

Senator GRAHAM. Now, I assume that the policy behind looking at the community-wide is that you want to give people who have a section 8 voucher the--some mobility to look throughout the entire community in order to find the place at which they want to rent, is that correct?

Mr. WEICHER. That is correct. Anywhere within the overall metropolitan area that they can find something renting for, say, $650 in this example, they would be able to use the voucher, the certificate.

Senator GRAHAM. And I understand that what the voucher means is that the Federal Government will pay the number of dollars that the voucher is worth, let's say $650 in this example, and they, the tenant, will contribute generally 30 percent of their income and if that is less than the $650, then the Federal Government pays the differential.

Is that correct?

Mr. WEICHER. That is exactly right, Senator.

Senator GRAHAM. All right. Then that theory operates on the basis of the potential tenant having geographic mobility. When we come to section 8 Mod Rehab, we are talking about a static structure. It is in a particular place. It is not mobile.

Let's assume under my example that in the lowest quartile of the community where the average rents are $400 we in fact build a hundred units of Mod Rehab housing, and that $400 reflects what the units in the marketplace are renting for in that particular neighborhood within the metropolitan area.

By using the approach that you have, which would assign to each one of those units a section 8 value of $650, are you immediately building in a noneconomic bonus of $250 a month into each unit?

Mr. WEICHER. We would not give a $650 payment in that example because there is a provision which says that the $650 is the ceiling. Then each project would be looked at separately, and if it is concluded that this unit would be worth $400 after completion and that the rehabilitation expenses that we will be paying for fit within the $400, the subsidy amount——

Senator **Graham**. Excuse me, I don't want to get confused with that because the statute says you start off with fair market rents and then you can adjust it up based on the amount of rehabilitation. I am still focusing on how you arrive at that baseline of fair market rent.

Now, how would you go about arriving at the baseline of what the fair market rent upon which any 20 percent or other additive could be layered? What is it—how would you go about arriving at your baseline?

Mr. **Weicher**. That is the procedure we have been describing. The figure for the fair market rent for the whole metropolitan area would be the $650, but we would not give $650 to a project that you described under the regulations because that project would not be worth $650 and the cost of rehabilitation would not make it worth $650. There is a difference between the contract rent and the fair market rent.

In many of the discussions with Mr. Adams he used terms backward. The specific project is calculated as you describe plus whatever the rehabilitation actually costs. No one is guaranteed a fair market rent of $650 under the Mod Rehab Program properly administered. No one is continued any set number based simply on a fair market rent for the whole metropolitan area.

Senator **Graham**. Could you point to the section of your testimony which describes in more detail how you would go about adjusting what—the $650 figure down to what would be a more appropriate fair market rental figure?

Mr. **Weicher**. That specific discussion is in Mr. Logue's testimony.

EXCEPTION RENTS

Mr. **Logue**. I did not read that testimony, but if you look on page 9, the second paragraph addresses exception rents as to—and I think that is what we are talking about. If I can take a stab at maybe differentiating and outlining the discussion.

The certificate fair market rents, the existing fair market rents are the base upon which we determine for all intents and purposes the Mod Rehab fair market rents, and essentially we have a first 20 percent increase on the existing certificate fair market rents. That is designed to account for the rehab expense, the amortization of the rehab expense that is typical in a Mod Rehab Program. The existing fair market rents really relate to an existing already built and occupiable and standard decent, safe, and sanitary unit, and we are talking about having to do additional rehab to bring a property back into or to bring it—upgrade it physically, which is what the Mod Rehab Program is designed to do. We have to also account for the rehab costs associated with that work, and that is basically the first 20 percent. That 20 percent then forms essentially 100 percent fair market rent for Mod Rehab Programs because it includes that additional component.

In addition to that, there are exceptions that can add an additional 20 percent on top of that, those two exceptions are the geographic increases that may be used if they are justified, can be incorporated into a specific project's rent and the unknown costs, behind-the-wall's cost, that might occur on a rehabilitation project.

Senator **GRAHAM**. What I am asking for is where is the provision that allows you to reduce the fair market rental down to $400 before you start to do the calculation of how much is appropriate for the rehabilitation?

Mr. **LOGUE**. That testimony is on page 3. It starts at the top of page 3.

Senator **GRAMHAM**. Again, it says, "The public housing authority is required to determine the rehabilitation necessary to bring the unit up to standard condition."

Is that what you are talking about?

Mr. **LOGUE**. Yes.

Senator **GRAHAM**. I am starting at a proceeding point. The statute makes very clear that you begin with fair market rent. Then you can adjust up to 20 percent. I am still focused on the beginning of that sentence, of how you arrive at the fair market rent and—and using my example, what is the procedure to get from the areawide $650 down to the $400 fair market rent; that is, the fair market rent in the specific static, nonmobile unit and neighborhood that is the object of this program.

I guess what I am concerned about, I think that we have a concept built on mobility, which was to give to the individual the right to move around the community and choose which when it got applied to a site specific application; i.e., a particular project with 100 Mod Rehab units in it, it didn't make any economic sense unless you can show me somewhere where those two divergent concepts of mobility versus static location are reconciled.

Mr. **WEICHER**. Let me try, Senator. Let us start with your $650 for the existing program fair market rent. Then the statute, as you quoted earlier, allows a fair market rent in the Mod Rehab Program that is 20 percent above that number. That would give us $780. Then there is behind the walls actual additional rehab cost that is discovered in the process which would give us up to another 20 percent. That gets us to $936. That becomes the maximum that the Department can pay.

But the specific contract rent on a project is calculated as described in Mr. Logue's testimony. But $936 becomes the ceiling and not a number which anyone gets automatically.

Senator **GRAHAM**. Again, as I read the statute, the landlord is entitled to get the fair market rent, and then it can be adjusted, as you have indicated, to levels above the fair market rent.

What I am trying to determine is how you arrive at that baseline of what the fair market rent is for a site specific application.

Mr. **WEICHER**. There isn't a separate fair market rent for each site, but there is a separate contract rent and a separate subsidy amount for each site based on the actual costs in that project and the actual value of the housing in that neighborhood.

I am trying to start with a fair market rent process, which applies to a metropolitan area and that is then modified for the Mod Rehab Program, but still applies to the overall metropolitan area, but then for each individual project is calculated under that ceiling—as established by the fair market rent is calculated under that ceiling separately for each project.

Senator GRAHAM. My time is out again.

Senator Bryan.

Senator BRYAN. Just one question. We're trying not to get to bogged down.

Assume hypothetically that you have got 100 units in the same neighborhood, two separate 100-unit apartment complexes, one of which is old, run down, dilapidated, but paid off entirely—in other words, the owner owes nothing on it. Clearly, there is a substantial rehab and an amortized cost that the owner will incur to rehab that, but in terms of the total amount that the owner is going to be paying, he may be paying far less in the sense of his obligations, his outlay. Assume that that 100 units that is across the street hypothetically was built more recently, it also needs some rehab work, but the owner owns a substantial amount of the first deed of trust.

Do the respective positions of the owners in terms of their own economic circumstances as it relates to their expense on each of these 100-unit projects I am hypothesizing—does that fit into the calculation at all?

Mr. LOGUE. We have to get back to the fact that the contract rent on a particular project is a cost based analysis, which means again we have a maximum which you are not automatically entitled to but which provides the ceiling that you would be allowed to go through under any circumstances.

Senator BRYAN. That is why I drew the two hypotheticals.

The first guy has far less costs than the second guy, and I guess from the taxpayer's perspective and from your administrative point of view I am not sure—the rents might ultimately, aside from any subsidy program in that area—let's say hypothetically the person could get—irrespective of the Mod Rehab Program, could get $750 a month rent. Clearly, the economic gain to the first owner is far greater than it would be to the second owner who has not yet paid off all of the units as a first trustee.

DETERMINING FEDERAL GOVERNMENTS SHARE OF SUBSIDY

Show me, if you will, just for this illustration how you all make the determination as to what the Federal Government's share of that subsidy should be and how it would work out.

Mr. LOGUE. Let me try and do it.

Senator BRYAN. Sure.

Mr. LOGUE. Basically, we would assess the cost of operating the development, real estate taxes, the utilities, management fees, that type of an analysis, and incorporate into that the cost of the debt that was attributable to the cost of rehabilitating the property, and basically that is where the—the first owner would not necessarily have the ability to—we are now talking in a nonsubsidized scenario. You would be able to charge what the market would bear, and that would establish his rent level irrespective of what his real costs were.

So his return on his equity would be higher than the second individual's who then has additional costs associated with it.

Senator BRYAN. Exactly.

Mr. LOGUE. If the process is carried out correctly and administratively proper, the cost to the Federal Government for maintaining rent to the first property owner would be lower. If all of the costs were certified and determined to be appropriate, then the individual in the second circumstances——

Senator BRYAN. The Federal Government would pay less to the first?

Mr. LOGUE. In that hypothetical scenario, yes.

Senator BRYAN. That seems to suggest—and I am going to yield my time back to Senator Graham—but that seems to suggest that it is almost on a public service commission concept. In other words, you are building in—now, maybe the Government in that hypothetical would get a break, I suppose, or at least you could argue it would with the costs, but if you build in the costs and you are not approaching this thing—I think where the Senator is coming from is we—as we read the law, the basic predicate, the bedrock is ascertaining fair market value, what the fair rental value is, not so much the calculations that you have just taken us through, Mr. Logue. It just seems to me that you are kind of in effect looking at each project theoretically and trying to develop the cost basis for the individual Mod Rehab developer, for lack of a better term, and you may get widely disparate views, and fair market rental doesn't seem to have much to do with that calculation.

Mr. LOGUE. Again, the fair market—maybe it is a problem with the determination of fair market or what fair market rents may represent in people's minds, but we use it at the Department as a guide for establishing appropriate costs to the Federal Government for providing decent, sanitary, and safe housing, and to the extent—basically the approach that we take would—again if it is applied appropriately—would assure that the Federal Government is not paying an unusually high return through subsidy payments to an owner when their actual costs would not be reflective of the—of that level of rent payment.

I think it is an appropriate methodology to utilize to assure that we are not going—that we are not oversubsidizing a particular project.

Senator BRYAN. I think for a lot of us—and then I am going to, as I indicated, yield my time—I think for a lot of us fair rental value—to me at least—has a connotation, if not in the regulatory sense that you are interpreting it—you know, if you went into a neighborhood what would be the fair rent to pay for that unit. That is the concept that at least comes to my mind, and having recently moved to the District, I can discuss it more than just as a hypothetical context. I can discuss specifics. That is what it means to me.

I think where I am a bit concerned is if that isn't the basic premise in which the subsidy is structured. We get involved in this cost to the owner in the hypothetical versus owner two. That strikes me as straying from what the statutory mandate suggests as far as fair market rental. That is just an observation, and I will yield my time back.

Senator **Graham**. I think Senator Bryan in 3 or 4 minutes stated what I was trying to get to in my 15 minutes. I do not believe that the way you are implementing the program is consistent with the statute, and I believe the way you are implementing the program is a significant part of why this cheese is so vulnerable.

Let me ask another issue. In a previous hearing it was observed that a number of the projects that are on the suspect list were in communities which had recently undergone economic decline. I don't want to be pejorative, so I won't list any of them. But you can think of where they might be, and that therefore the fair market rental was, let's say, at a 1984 standard when the actual activity was taking place in 1987 or 1988 after a drop, and so developers were able to come in, buy properties at their 1987 or 1988 value, but rent them back to the Government at a 1984 level of fair market value, which was in fact above the market of the current date.

Do you see that as being a problem and, if so, do you have any recommendations as to how to deal with it within your procedures?

RENTS IN AREAS OF ECONOMIC DECLINE

Mr. **Weicher**. I have looked at some of the testimony from your hearing of August 2, which I think may be what you are referring to. Mr. Schussheim from the Congressional Research Service looked at something like 20 projects.

There are average annual adjustment procedures for each fair market rent area in the United States. The question I think would turn on whether the program, the rent available under the program is adjusted as the market turns soft on you after you have made the initial commitment. I am not sure what the program procedure is in that case. We might need to provide that information to you for the record.

Senator **Graham**. There is in my judgment another vulnerability of this program, the time gap between when what is supposed to be fair market rent is established and the actual time when a 15-year commitment is entered into for the future rental subsidies.

Let me ask about another area which will be the subject of our next hearing, and that is the role of coinsurance. As I understand it, under the process that HUD has used in many of these projects a coinsurer has been given the authority to determine what fair market rent and what is appropriate as the additive for rehabilitation, and it has been suggested in that August 2 hearing that there was a tremendous conflict of interest there because the coinsurer has an interest in having the rents as high as possible to give him greater security that he won't be called upon. Also, typically in these projects the coinsurer is paid a fee, which is a percentage of the size of the mortgage, and the higher the rents the higher the mortgage that can be supported, and therefore the higher the fee.

What is the rationale of giving to a coinsurer the authority to set or be substantially influential in establishing what the rent structure would be?

ESTABLISHING RENTAL RATES AND THE COINSURER

Mr. LOGUE. That is a particular issue that the Department has addressed as it became apparent. I don't think there was at any point in time explicit authority for a coinsuring lender to set rates outside of the Mod Rehab process that would be established under Mod Rehab programs that would have worked independently.

The Department has established a procedure at this point to assure that that does not happen, whereby in any coinsured project that also has Mod Rehab the field office will be the entity that will be responsible for establishing the rent. So that kind of process—and I think possibly contravention of the intended regulation—would not have an opportunity to present itself again.

And as I mentioned earlier, we will be reviewing somewhere around 300 cases—and many of these are coinsured, Mod Rehab cases—the rent calculation process that was established or utilized to establish those rents, and if they are in conflict with the program regulations, we will take action.

Senator GRAHAM. Another area of alleged abuse was the granting of waivers for rehabilitation costs beyond what was established. The information in our previous hearings is that there had been a pattern of greater liberality in granting such waivers.

Is that consistent with your analysis of the program and, if so, what action is being taken on that?

WAIVERS FOR REHABILITATION COSTS

Mr. LOGUE. Well, there are two areas that have, I assume, potential areas for abuse. There are two circumstances. There is a waiver provision of regulations that, to my understanding and to my staff's analysis so far, has been fairly limited; in other words, waivers by the Assistant Secretary for Housing for rents in excess of the—of a prescribed aspect of the program were not frequent, but I cannot tell you right now how many there were. But we are looking at that in conjunction with the inspector general.

Senator GRAHAM. I would also like in conjunction with that analysis a legal opinion as to where in the statute authority for such waivers beyond those that are specifically authorized in the statute is granted.

Mr. LOGUE. I do not know that the statute would permit anything beyond what is legally permissible. I would assume that waivers would be permitted waivers, but we will look at your question and try to respond to that.

The other important area which I think has been the focus of more concern, to my understanding, has been in the granting of exception rents, and if we go back to the description of how rents can be increased at the field office level without a waiver process necessarily, there are specific regulatory provisions that would allow a field office and in some instances the field office with permission of the central office to allow rents to go up to 20 percent above the Mod Rehab fair market rent. If certain findings were made—and again the two exception areas would be where the local area's rent level is higher and can be demonstrated to be higher through economists' econometric samplings of the area—then the existing—Mod Rehab fair market rent—and that should be supported by a field office and regional economist's assessment of that market area, and if the regulatory tests are met they would be entitled to receive that expection rent.

Now, the question is whether or not in fact the field office has performed and assured themselves that those provisions were met. That is the question.

The other area, again, is in the other exception, which would be for costs that were not identified in the initial estimation of costs that were behind-the-wall costs that would only become obvious and apparent when the rehab work occurred, and again if there is a demonstration that these costs were legitimate, they were unknown at the time when the initial rents were set, and that they had to be accomplished in order to meet decent, safe, and sanitary standards, then the field office again, assuming those areas were met, could approve up to 20 percent cost exceptions to the fair market rent, and again our field office—our field audits—there are 300 audits that we will be doing—will be addressing and looking into those circumstances, also, and to assure that the appropriate regulatory criteria were met.

BEHIND-THE-WALL COSTS

Senator GRAHAM. Let me ask a couple of questions based on what you just said. You talked about behind-the-wall costs.

Are there some examples of where when they got behind the walls they found out that actually the rehabilitation was not going to be as extensive as initially proposed, that it had better plumbing and electrical than had been anticipated?

Mr. LOGUE. I cannot point to any, and that generally--I have been involved in my previous work with a significant amount of rehabilitation. That is generally not the situation, and I really couldn't comment on whether it happened or did not happen.

But one of the things that I think within the process that would address that concern is a cost certification process that has to occur after the construction work is completed. If you didn't have to do something that you orginally planned and set aside funds to do so and you did not spend that money, then the rehab loan should be reduced and the rents reduced commensurately without not having had to perform that work.

So there is a system in place that should address circumstances of that nature.

Senator GRAHAM. How were the 300 projects that you are going to be evaluating selected?

Mr. LOGUE. Basically in consultation with the inspector general's reviews, and they are basically projects of 50 units or more.

Senator GRAHAM. And when will the information from that be available?

Mr. LOGUE. The process, the training for the field staff, the people who will do these audits will begin in the first fiscal—the first quarter of the fiscal year, in the next couple of months.

Senator GRAHAM. Have you considered directing the inspector general, who already has some expertise in this area, to do the work rather than have another component within HUD do it?

Mr. LOGUE. The inspector general's office, to my understanding, does not do that type of work and they are expecting us to do it, but they have identified what they believe we should have to do and we have responded to their concerns with this plan.

Senator GRAHAM. I would be very interested in the results of that study, particularly in terms of the extent to which behind-the-wall costs tended to occur, whether there were any examples of behind-the-wall savings occurring from—both Senator Bryan and I had the opportunity as Governors of our State—I know at least in my State one of our concerns with a large construction agency such as our Department of Transportation was to avoid a pattern in which contractors bid low to get the work and then came in after they had gotten the contract with a lot of add-on costs which ended up—could end up with them having been the high bidder had they in fact incorporated all of those costs in their original bid.

And I am concerned that since HUD has to make some judgments about how to allocate limited moneys that if you give it to a developer on the assumption that your cost is going to be $600 a month and that is a competitive price vis-a-vis your other alternatives and end up paying $800 a month because maybe he purposely understated what his costs were going to be, that the taxpayers have been subjected to another ripoff.

Mr. LOGUE. I understand your concern, and it is a concern in any field, whether it is housing or some other area. Much of this is really a function of the quality of the developer and the contractor and the people who are reviewing their submissions on a technical basis to determine whether or not we have substantial or moderate rehab of housing. It is something that when you get into the track record, is that there are expenses that are not discernible at the beginning and—the question is whether they are legitimate or whether they are not legitimate. That is a function probably less of regulation than it is of quality, oversight, and monitoring, which is quite frankly not consistent probably in HUD or in other areas.

Senator BRYAN. A philosophical question. Does the Department of Housing provide assistance directly to individuals who would fall within the income eligibility guidelines of subsidized housing for an individual who goes into a housing unit that is not a Mod Rehab project as such, but would fit within the fair rental values that we are talking about here, or is this program so skewed that it only takes vintage of a Mod Rehab development, that is the only way you get a subsidized payment or voucher from the Federal Government?

Mr. LOGUE. Well, our certificate and voucher programs would be available and do exactly your first scenario, which is the tenant would have the opportunity to choose and find the unit that they wish to occupy, and it really gets to the difference between a project based type of a system, which is a Mod Rehab Program, and the certificate and voucher programs, which are tenant specific as opposed to project specific.

Senator BRYAN. Again, where I am coming from, if the object of all of these programs is affordable housing to help those whose income levels are below the ascertainable level for providing decent, safe—all of the criteria that you have incorporated in your testimony—all of this incantation of how we calculate the cost and what factors we weigh for that strike me as being incredibly complex, and I don't want my questions to have been viewed in a pejorative sense because I realize as administrators—as Senator Graham has indicated, in a former life both of us were administrators in a sense, and so I have some considerable sympathy for you in terms of managing a program that is that vast and that complex and to do something that has got an ascertainable center to work from. But it just seems to me that all of the calculations that are required to reach the conclusions that you have shared with us, that there ought to be a simpler way to do it to achieve the social objective that I hope all of us agreed to, and that is to provide affordable housing. It just strikes me as being ungodly difficult for you to manage and for us in our oversight responsibilities to try to frame the statutory guidelines and hold all of you to a standard of accountability when it is very, very difficult to see these calculations as they unfold, and they are subject to some value judgments.

Mr. LOGUE. Absolutely. I think you have hit on a particularly relevant point. The purpose of Mod Rehab as opposed to vouchers and certificates was to upgrade existing housing where it didn't exist before and make it affordable to low income individuals. When you get into issues of having a tight rental market, such as the Northeast and other areas of the country have experienced, there isn't a supply of affordable rental housing available to low income tenants. The issue is then not a matter of whether they can afford it, but can they find it, and then you have to provide housing—or I assume the thinking in this program was to provide an opportunity to provide additional rental housing resources affordable to low income individuals. If you have a decent supply of housing stock and it is an affordability issue, that would be where the voucher and certificate program should work.

And I could not agree with you more in your assessment of the process that we as administrators have to go through in order to assure with some reasonable certitude that the program is accountable and that the—there are so many variations that we have to take into consideration, and as you know, every time you want to do something you have got to develop a regulation, and that regulation is subject to interpretation. It is not an easy process, and it would be nice to be in a position where we all trusted—everybody could trust everybody to do their job right, but unfortunately——

Senator BRYAN. I am not unsympathetic, and I am sure that Senator Graham is not either, but I think that that is why both of us—and we have not discussed this prior to this hearing—but both of us kind of come back to the baseline that if the premise is the fair rental value as opposed to all of those individual component parts, it is something that it strikes us that there is some common ground that reasonable folks can ascertain what a fair rental value is in a neighborhood, that that doesn't require a rocket scientist to do that job or somebody with a Ph.D. in mathematics or in economics. You know, in effect, if you live in a community, if you have some experience, in effect what housing costs are.

I am speaking in generalities. You know that that rent—that is in the ballpark. That is way up. We can do a lot better than that, and then if you structure your programs from that premise, it just seems to us that it may be easier than trying to build those individual components which may have such enormous variables and that are so very difficult to craft regulations to address.

Mr. LOGUE. The issue there may be—again, if you look at the differences in the objectives of the program, one is a supply side oriented program and the other is a demand side program really when you break it down. You have to—if the certificate levels theoretically were at a level where people would go out and develop housing, new housing in tight rental markets, and that provided the incentive for somebody to do that, then we probably wouldn't need a differentiation in the rents. But that has not been generally the experience. To get housing built that doesn't exist in certain market areas could not be supported by, let's say, the 120 percent of the existing FMR levels because you just wouldn't get anything done.

I think it is a function of what the program is intended to do, and the program for vouchers and certificates has a different orientation than for Mod Rehab.

Senator BRYAN. But wouldn't it in theory—and your boss is a great advocate of the free enterprise system—but wouldn't it in theory—if the Federal Government in the voucher program designed that in such a way that the voucher supplement combined with the ability of the subsidized pay would equal what the true fair market value of that rental unit would be, wouldn't that provide the economic stimulus for developers to in effect build more rental units?

Mr. LOGUE. My experience has shown that that would not.

Senator BRYAN. That would not. In other words, a developer doesn't look—irrespective of subsidized levels, take a look and say this is a community that has got some housing needs that need to be addressed, if I can build, you know, a set of apartments and in effect get a reasonable rate of return based upon what the fair market value is in the neighborhood, irrespective now of the complicated subsidy formulas, I would think that that would be—but you say no.

Mr. LOGUE. It just has not been the experience, and again that has not been the experience in the higher priced market areas. I come from New Jersey, and rental housing on a conventional level for all intents and purposes hasn't been developed other than a scattered few units in the last 5 or 6 years. That has resulted in pretty significant rental housing crunches, particularly for lower income individuals, and there the answer really is supply of that type of affordable housing, and you would not get it on the rent levels that would be applicable to the certificate existing fair market rental.

Senator BRYAN. I don't disagree with you that there is certainly a lack of affordable housing. That is clear in my mind. The question is how do we create the economic stimulus to create more so that people who are sorely pressed to find affordable housing have it? That is the challenge.

Mr. Chairman, thank you so much.

Senator GRAHAM. Thank you, Senator.

I just have a few concluding questions to ask, and I notice at the beginning, Mr. Logue, of your statement on page 2 you say that when the Department designed the Moderate Rehabilitation Program in 1978 it was in recognition that there was a major segment of the housing stock that was not being addressed, and then you go on to state that to target that the Department designed a program which would offer financial incentives to the small owner administered by public housing agencies so that technical assistance to owners would be available at the local level and that the redtape of Federal requirements would be limited.

From the fact that owners have had to pay $1,000 a unit to expediters in Washington, to the complexity that you have described in the last few minutes of your testimony, would you say that objective of the program of simplicity has been achieved?

Mr. LOGUE. I think clearly the recent experience with the program really resulted from the fact that the fair sharing aspect of the program—it became a headquarters driven program that was not doing what—was not the original intent. I would say that clearly it has not in recent years been meeting that objective.

Senator GRAHAM. Mr. Weicher, prior to coming to HUD you were at the Office of Management and Budget, is that correct?

Mr. WEICHER. Yes. I was Associate Director for Economic Policy there from November 1987 until April of this year.

Senator GRAHAM. Is OMB structured in such a way that there are units with responsibility for oversight of line agencies such as HUD?

OVERSIGHT BY OMB

Mr. WEICHER. Yes. There is a branch for each Cabinet agency reporting in a structure through an Associate Director with responsibility for several Cabinet agencies and above the Associate Director is the Director and the Deputy Director.

Senator GRAHAM. At your previous position at OMB did you have any responsibility for oversight of HUD?

Mr. WEICHER. No. I was Associate Director for Economic Policy, and I had no oversight responsibility for any agency. I was there as chief economist, as forecaster, with responsibility for developing policy in some cross-cutting areas that went across departmental lines. But I had no responsibility for any program, any budget in the whole Government of the United States.

Senator GRAHAM. Based on your experience at OMB, what do you have to say about the degree of oversight which was provided the programs in HUD?

Mr. WEICHER. The degree of oversight at OMB I think it is—I cannot really give you any very specific answer on that. I notice that Mr. Darman has asked the agencies to provide him with guidance on potential problems along the lines of the HUD scandals.

I think that—let me stop there. I am not really sure whether the agency is or is not structured to pick up problems of fraud out of a line item budget analysis. I really cannot give you an answer on that. I didn't have responsibility for it, and I did not discuss that with anyone who did.

Senator GRAHAM. You used the word "fraud." Now, whether there was actual fraud and illegality in this I guess is an issue that we will be coming to later, but there were clearly indicators that an agency exercising oversight for the White House would have been able to have detected the fact that the program was moving from its original relatively small projects to much larger projects, the fact that there were changes in the way in which relationships between the central office and the field offices were being conducted would just be two discernible examples that something was happening here.

In your experience at OMB, were there systems of controls such that those kinds of indicators would have signaled a situation that warranted some further review?

Mr. **Weicher**. I really cannot tell you whether the systems are in place to do that or not, Senator. I would like to be able to answer that question. I had other responsibilities there. The issue—these programs—I do not remember anybody discussing Mod Rehab as a program with problems, but there is no reason why I would have known if a budget examiner within the housing branch thought that there was a problem there. The chain in which that was discussed would not necessarily have included me.

Senator **Graham**. Who was the person in OMB who would have had responsibility for the HUD programs?

Mr. **Weicher**. The Associate Director on my level at the time I was there was Carol Crawford. She was the Associate Director for Economics and Government.

Senator **Graham**. And it would have been under her portfolio that HUD would have fallen?

Mr. **Weicher**. That is right, that is right.

Senator **Graham**. Mr. Adams had made some recommendation as to possible corrective actions that should be taken. One was to restore fair share allocation, which you indicate has already occurred. Another was to eliminate the stacking of benefits. You have indicated that you are exploring that. Another one was to assure that there would be an allocation between families, elderly, handicapped, that would be responsive to a local assessment of the need among those groups.

He didn't suggest, but I would like to suggest as another possible remedy, recapture of benefits. When we talk about the amount of money that the Federal Government is going to "lose"; that is, how much more it will have to pay than it would have to secure the same benefits, most of that loss is prospective. Most of these projects are in the early stages of a 15-year contract. Most of them are in the early stages of a 10-year low income tax credit arrangement.

Do you have any ideas as to how we can go back in, recalculate these transactions on the real economic worth, and avoid a windfall of profit and a windfall of taxpayer distress?

Mr. **Logue**. Let me try and respond to that because those are some of the things that we are putting into place, and to the extent that we can achieve those goals, we will achieve them.

In the coinsurance area, we are currently reviewing our entire coinsurance program. As you know, the Secretary suspended certain aspects of the coinsurance program early on in his administration as a result of some of the revelations that came out of this and other reports from the inspector general. While we are not in a position to fill in the details yet, that is imminent and it will in fact occur, I believe, before we have a coinsurance program back out making loans. We want to assure that the coinsurance program is effective and efficient, and particularly with regard to Mod Rehab, that the applicable rules governing both programs, both Mod Rehab and coinsurance, will be followed. On the retrospective look many of the projects that we will be reviewing through the audit process that we will be beginning next quarter will look specifically at projects that are both Mod Rehab and coinsured.

Now, it is tough to get an appreciation of some of the difficulties we will face in that kind of an analysis. For instance, we may be in a position where Mod Rehab rents were inappropriately calculated on a coinsured project, and while we may have the authority to reduce the rents and save rental budget authority in the future, we may on the other side be in a position where—we might be in a position where the coinsured loan may become troubled as a result of reducing the rents since the coinsured loan was based upon them, upon the Mod Rehab rents.

So we have to do an assessment as to the benefits of reducing rents versus taking a risk that an insured, an FHA-insured loan essentially will get into trouble. We may then have to pay out of the insurance fund.

Those are some of the complexities which we will be dealing with, but generally speaking, as far as our ability to reduce rents on Mod Rehab projects that we find were inappropriately calculated, our position is that we will take whatever action we can to reduce those rents, keeping in mind other implications to the Federal Government that might occur from that.

But our job and our—in fact in a number of instances in some Mod Rehab projects we have already instituted rent reductions where we found that the rents were inappropriately calculated.

Senator GRAHAM. I would hope that that analysis is on an expedited basis because every month that goes forward if those rents were inflated to the detriment of the taxpayer we continue to bleed.

Is there any action that Congress can take that would facilitate that reexamination and potential recapture of windfalls?

Mr. LOGUE. I cannot think of any off the top of my head. I would like the opportunity to discuss that with staff and, if we have something, to come back to you.

Senator GRAHAM. I would particularly urge you to look at this question of stacking of benefits where the rents did not take into account the fact that the developer was also getting substantial tax credits, did not take into account the fact that he was financing with tax-free bonds, maybe did not take into effect other State and local benefits that were being available which made the transaction move from a reasonable one to self-engorging—a self-engorging process.

Are there any other congressional actions that you would recommend beyond those that Mr. Adams suggested and the recapture proposal?

Mr. LOGUE. Not off the top of my head.

Senator GRAHAM. One of the things that has come up in the savings and loans issue and it was in your testimony today is the fact that HUD didn't have—HUD or the Federal Home Loan Bank

Board didn't have enough staff to do adequate supervision. That becomes a budgetary question.

Are you satisfied that the level of funding for the supervisory functions of the Department in the HUD appropriations bill that is currently pending before Congress is adequate?

ADEQUATE STAFF

Mr. LOGUE. I am not totally familiar with what the implications to housing are within the overall departmental staffing allocations. We are currently doing a review administratively and within Housing of allocation of resources and what we need to do the job, and I don't have any specific recommendations for you with regard to the immediate future, but the question we need to address as a new management team is, No. 1, do we have enough people and, No. 2, are the people we have involved in the right type of work and do we have our existing resources allocated properly to assure that we can do the job we are supposed to do.

And we are not completed with that assessment. So I cannot comment as to whether or not the proposed levels of funding would be adequate or not adequate. But I think what I have seen so far with some—I think a lot of the problem is just the orientation of the leadership at HUD to the career staff, who by and large are extremely effective and competent, to give them clear direction as to what areas we think are necessary for them to spend the bulk of their time.

Senator GRAHAM. Well, I am pleased with the new winds that are blowing in HUD, and I share the comments that have been made about our support and optimism for the new Secretary and his colleagues.

Looking at page 6 of your testimony, you identify as problems headquarters programs, staff was not given adequate resources to continue to provide needed program guidance material, training, and monitoring. HUD field offices were not given adequate staff and indications of priorities to monitor and implement the program.

Those are hard personnel resource-related issues. I previously put in your court an assessment of whether any congressional action was necessary relative to fair share allocation. I am now going to put in your court the question of adequate resources to deal with the issues that you have documented as contributing to this problem, and if you don't bring the ball back on our side of the court before we take up the HUD appropriations bill, I am going to assume that the Department is satisfied that when it writes its report next year it won't cite as a reason for concern failure to have the adequate resources to do its required supervision.

Is that a fair game?

Mr. LOGUE. That is eminently fair.

Senator GRAHAM. I have no further questions. I want to thank you for your very illuminating testimony. I am sorry that we spent so much time in some of the details of fair market rent, but I consider that to be one of the core issues because, in my opinion, the way in which it has been calculated has been a basic reason why we are in the problem that we are, that it created one of the major areas of abuse.

In an article I read yesterday describing the Argentine economy, it said that they had the worst economic system imaginable. It had socialism without a plan, it had capitalism without a free market. I believe that in some ways that statement could be applied to the way in which rents have been calculated by HUD. It is socialism without a plan, capitalism without a touchstone of the free market.

It is for that fundamental reason that I believe that the kinds of remedies that you suggest beginning on page 6, 7, and 8 may be too timid. I believe that we need to attack aggressively basic issues of how we calculate fair market rent so that we have the external discipline of the market controlling more of this process and therefore reducing the vulnerability that through political decisions or political manipulations or graft or fraud or worse that the program will be perverted away from its intended purpose and that the taxpayers won't get the maximum benefit of housing for low and moderate income Americans that they are entitled to receive.

Thank you very much.

[Whereupon, at 1:28 p.m., the committee was adjourned.]

ABUSES IN THE SECTION 8 MODERATE REHABILITATION PROGRAM

THURSDAY, SEPTEMBER 28, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Garn, Graham, Pressler, Wirth, and Cranston.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

We want to welcome our witnesses this morning. I want to make brief opening comments, and then we will call on Senator Garn and Senator Graham, and we will proceed with the inspector general.

Our hearing this morning is the second in a series of three that are focusing on the Moderate Rehabilitation Program and how its use in conjunction with other Federal programs made mod rehab ripe for abuse by individuals inside and outside of the Department of Housing and Urban Development.

In the first hearing, we examined how problems in calculating the rents for mod rehab projects allowed rents in excess of prevailing rents for the area in which the project was located, and allowed those to be charged for the mod rehab units. In tomorrow's hearing, we will be examining in greater detail the role of the low income housing tax credits.

Our focus this morning is on the use of the coinsurance with the Moderate Rehabilitation Program, and how it contributed to the abuses we have seen in our hearings and heard about through the national media during the last several months.

Just to cite one example, we have found in one case of the coinsurer Benton Mortgage that the IG estimates that, from the 14 projects it reviewed, these mortgages were overvalued by $22 million, and that excessive rent subsidies in these projects could be as much as $37 million. Obviously, that is not an isolated example.

Before we hear from our witnesses this morning, I want to again compliment Senator Graham for his strong and continuing leadership in this area. I think these hearings provide a very important opportunity for us to get the basic facts in place as to how these programs were abused, and they lay the foundation for legislative changes and other actions that the committee will take in the future.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Due to the fact that we have a vote at 10 a.m., and I have another problem in that it is the time of year that we all dread, the end of the fiscal year, and being a member of the Appropriations Committee I have three different conferences I am supposed to be to right now—I am going to flip a coin and decide which one I should attend. But I have rather a long opening statement today, and so I simply ask unanimous consent that it be placed in the record.

The CHAIRMAN. Without objection, so ordered.

STATEMENT OF SENATOR GARN

Senator GARN. Mr. Chairman, I am pleased to be here today to continue the investigation into the Moderate Rehabilitation Program. This committee has held a number of hearings on the Moderate Rehabilitation Program. We have learned that Moderate Rehabilitation projects were extremely lucrative because: (1) Section 8 Fair Market Rents for this program were 20–30 percent higher than those usually allocated, (2) many of these projects received more Federal subsidy than necessary—tax credits and section 8, and (3) a number of the projects were subject to the benefits from Federal coinsurance. This hearing will focus on this last category, the role of coinsurance with Moderate Rehabilitation projects.

Very little is known about the relationship between the Moderate Rehabilitation and coinsurance programs. We do have a general idea about the scope of the relationship. Since 1984, about 270 Moderate Rehabilitation projects were approved. Of the 270 projects, 55 were coinsured. Of the 55, 49 were insured by Benton Mortgage Co. The remaining 6 were insured by DRG, Carnagie Evans, and York.

Although we do not have a clear idea about the interrelationship between the two programs, past hearings have revealed that coinsurance clearly played a role in making a Moderate Rehabilitation project more attractive.

In order to understand how the two programs are connected, it may help to understand the evolution of the coinsurance program. The coinsurance program began when processing times for applications in HUD's full insurance program were increasing substantially. In addition, the agency was experiencing severe staff cuts, particularly in the field offices. Coinsurance represented a means to "contract out" to the private sector for multifamily underwriting, freeing HUD from underwriting each and every loan.

Under coinsurance, the lender performs its own underwriting and "coinsures" the loan by agreeing to pay the first 5 percent of any loss and 15 percent of all losses above and beyond that amount. In theory, the risk to the lender under this arrangement provides an incentive for sound underwriting, and the elimination of HUD from several stages of the loan origination process greatly simplifies and expedites loan processing.

In reality, the program did not work as intended and has confronted numerous problems. Since 1983, 1,464 multifamily projects have been granted coinsured mortgages totalling $9.5 billion. More than 150—10 percent—of those projects are now in default.

Recent estimates set total losses for the program at over $900 million—9.5 percent of total mortgage balances. Roughly two-thirds of the losses incurred to date result from the activities of a single company, DRG Mortgage of Washington, DC. DRG's coinsurance portfolio accounted for over 70 percent of the defaults in the entire 223(f) coinsurance program and approximately 77 percent of the total principal and accrued interest outstanding on defaulted 223(f) coinsured mortgages.

Problems with the coinsurance program seem to stem from three sources. First, program design flaws encouraged lenders to insure short-term, high risk loans. The long-term risk of the loan was outweighed by lucrative upfront fees and minimal capital requirements.

Second, the Department of Housing and Urban Development did not monitor adequately those lenders who participated in the coinsurance program. Proper monitoring and oversight are essential if the Department chooses to "contract out" underwriting for projects for which the Federal Government is ultimately liable.

Third, the lack of oversight created an opportunity for fraud. The program used only a handful of lenders. There were consistent patterns of lending amounts substantially greater than actual property values, unrealistic occupancy projections, and excessive rent income projections. All of these increased the liability to the Federal Government.

Although many of the problems with the coinsurance program apply to coinsured Moderate Rehabilitation projects, these projects do have one unique quality. Federal action to adjust rents to a more reasonable rate may affect the viability of the project. In other words, a reduction in the section 8 rental assistance could cause the lender to default on the mortgage, ultimately causing the FHA fund to absorb 80 percent of the loss. Consequently, HUD is forced to weigh the merits of continuing 15 years of inflated rental assistance or taking a potential default on a project. HUD is currently assessing this issue on a project-by-project basis.

I am committed to discovering the full extent of favoritism and abuse with this program. I look forward to working with the inspector general and my colleagues to ensure that Federal housing dollars are used effectively and efficiently for those individuals who are most in need.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Mr. Chairman, I have no opening statement.

The CHAIRMAN. Very good.

In the course of this effort this morning, I am going to be asking Senator Graham to conduct the hearing. But let us begin now, Mr. Adams, with your testimony.

STATEMENT OF PAUL A. ADAMS, INSPECTOR GENERAL, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY CHRIS GREER, ASSISTANT INSPECTOR GENERAL FOR AUDIT, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC

Mr. ADAMS. With your permission, I will submit my testimony for the record, and then summarize, if I might.

LOAN UNDERWRITING

Because of the inherent vulnerabilities of the coinsurance program, we decided to perform some audit work. Our first audit started in October 1984, and we concluded that inappropriate lender underwriting practices had caused inflated mortgages for the eight specific projects we reviewed with coinsured loans, of $115 million. We estimate that the mortgages were excessive by some $36 million.

HUD management did not agree with our assessment of the program, and they characterized our findings as unfair and unjustified, since the lender shares in any loss and no foreclosures had occurred.

A second internal audit started in June 1987, about 18 months later. We found continuing significant problems in loan underwriting. We also concluded that the lenders were not aggressively servicing the loans. At the time of this audit, unlike the first, many of the loans had defaulted. In fact, 106, or 13 percent of all loans were in default.

We recommended major revisions to the structure of the program, and strengthening HUD's posture regarding enforcement activities. Again, HUD's management reacted slowly to our report, basically stating that we were overstating the nature and extent of the problem. While they agreed to improve some controls, they disagreed with those recommendations dealing with program design changes.

Shortly after Secretary Kemp took office, we briefed him and his staff on several of our major concerns. Coinsurance was among those. The new management team has taken many actions to address the program's problems, including the recommendations in our audit report. The program staff has completed a comprehensive evaluation of the coinsurance program that will result in major changes.

Prior to the reforms just mentioned, our office also performed external audits covering two of the larger lenders. We reported problems concerning DRG funding in January 1988, and recommended to the former Assistant Secretary that DRG be precluded from making any additional loans until they corrected the underwriting weaknesses.

At the time of our report, 79 of DRG's 272 coinsured loans, or 29 percent, were in default. DRG's defaulted loans amounted to nearly $538 million, or 77 percent of all defaulted coinsured loans. DRG's management practices disregarded HUD's underwriting requirements, contributing to its high default rate.

For 11 loans on which DRG had submitted claims at the time of our audit, HUD estimated an eventual loss of about $55 million.

More recent data shows that 20 DRG claims were paid, or are in the process of being paid, with an estimated loss to HUD of some $88 million.

Program-wide, there were 30 claims submitted with an estimated loss to HUD of $111 million. GAO testified yesterday before this committee that the estimated loss in the coinsurance program could reach $960 million.

BENTON MORTGAGE CO.

A second major effort regarding a coinsured lender was our audit of Benton Mortgage Co. We reviewed 14 loans for projects receiving section 8 mod rehab subsidies, and found processing problems with each of them. Our March report discussed deficiencies in Benton's valuation, mortgage credit, and architectural review process, resulting in material misrepresentations of the mortgage amounts and rents.

We concluded that mortgages totaling $75 million for the 14 projects we reviewed were excessive by $22 million. In addition, excessive section 8 subsidies of $37 million will be paid for those 14 projects over the 15-year contract period, unless HUD successfully reduces the contract rents.

We recommended that HUD's Mortgagee Review Board take appropriate sanctions against them, and the Board is presently reviewing those recommendations. The Benton report also pointed out significant weaknesses in the section 8 Mod Rehab Program. Our April 1989 report on the Mod Rehab Program discusses the lack of adequate cost controls when mod rehab projects were coinsured.

Essentially, HUD allowed the coinsurers to establish both the section 8 rental rates and the insured mortgage amounts, with little or no HUD oversight. In response to our audit, the Office of Housing issued revised guidance to HUD staff and coinsured lenders in May of this year. The new procedures will address prospectively the problems that we noted.

Mr. Chairman, I am encouraged by the recent actions taken by Secretary Kemp to enforce the program requirements, on the one hand, while taking a hard look at the program design. We are working with Assistant Secretary Fitts and her staff to effect some of these needed changes.

That concludes my comments, and I will be pleased to respond to any questions you may have.

[The complete prepared statement of Paul A. Adams follows:]

Statement of
Paul A. Adams, Inspector General
Department of Housing and Urban Development
Accompanied by Chris Greer, Assistant Inspector General for Audit
Before the Committee on Banking, Housing, and
Urban Affairs
United States Senate
September 28, 1989

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss our Office's efforts over the years in pointing out ways to improve the Department of Housing and Urban Development's (HUD's) administration of the Coinsurance Program. Accompanying me today is Chris Greer, Assistant Inspector General for Audit.

The Coinsurance Program, by its very nature, contains numerous complex issues and technical features that are not easy to learn or to understand. However, we believe the management issues we will discuss today are not that complicated. The Coinsurance Program concept was put in place at HUD during 1983. Basically, the Program calls for mortgage lenders to perform all functions relating to loan approval, independent from HUD. In exchange for the autonomy and the loan processing fees of about 4 percent of the mortgage amount, lenders accept responsibility for dealing with defaulted mortgages and ultimately share any losses incurred in the event of foreclosure. For example, the lender assumes the first 5 percent of any loss and shares 15 percent of any remaining loss with HUD.

The Office of Inspector General's basic responsibility under the Inspector General Act of 1978 is to provide guidance and make recommendations for promoting economy, efficiency, and effectiveness, and preventing fraud and abuse. In this regard, our Office has had input into the program since its inception.

During the Summer and Fall of 1983, as part of a Front End Risk Analysis, a system established by our Office to identify needed internal controls, we provided comments to program staff for establishing guidelines for monitoring and taking enforcement actions to reduce HUD's vulnerability to losses. Management agreed to include such controls in the coinsurance program.

Because of the inherent vulnerabilities associated with this totally new program, our Office decided to perform an audit shortly after program activity started. Our first report was issued in November 1985 and, on at least five occasions since, we have reported to HUD management that program improvements were needed. We are attaching excerpts of each such report for the record. The audits consisted of two reviews of program operations through the internal process, and two external audits of individual lender performance. A summary of the audit activities, our reports, and management's reactions follows:

Our first audit started in October 1984. We concluded that inappropriate lender underwriting practices caused inflated mortgages. For the eight specific projects we reviewed with coinsured loans of $115 million, we estimated that the mortgages were excessive by $36 million. HUD management did not agree with our assessment of the program. They characterized our findings as unfair and unjustified since the lender shares in any loss and no foreclosures had occurred.

To overcome the deficiencies noted during our audit, we recommended several measures to improve HUD's control over loan amounts and potential losses. In response, Housing officials stated that the controls we suggested were too strict and would impair the coinsurance concept. As an alternative, they agreed to improve their lender monitoring processes and enforcement actions.

A second internal audit was started in June 1987, about 18 months after the first report. The audit was designed to follow up on the previously reported underwriting deficiencies that caused inflated mortgages and to evaluate lender loan servicing. We found continuing significant problems in loan underwriting. We also concluded that lenders were not aggressively servicing loans. At the time of this audit, unlike the first one, many loans had defaulted (106 or 13 percent of all loans). In our report dated December 9, 1988, we recommended major revisions to the structure of the program and strengthening HUD's posture regarding enforcement activities. Again, HUD management's reaction to our report was basically that we were overstating the nature and extent of the problems. While they agreed to improve some controls, they disagreed with those recommendations dealing with program design changes.

Shortly after Secretary Kemp took office, we briefed him and his staff on several of our major concerns. Coinsurance was one of those concerns. The new management team has taken many actions to address the program's problems, including the recommendations in our audit report. Program staff have completed a comprehensive evaluation of the coinsurance programs that will result in major program changes. Since April of this year, HUD has already initiated the following actions:

(1) Moratorium on new coinsuring lenders.

(2) Expansion of HUD monitoring, including a review of all coinsured loans and projects.

(3) Evaluation of all active lenders, including underwriting, defaults, capitalization, and compliance with program requirements.

(4) Review and revision of program requirements, including lender approval process, project appraisal, loan underwriting, loan management, monitoring and enforcement actions.

(5) Increased enforcement actions, including suspension of four lenders, probation for five lenders, and close monitoring of three more lenders.

(6) Suspension of the coinsured Retirement Services Center Program.

(7) Reorganization of the coinsurance function.

Prior to the reforms just mentioned, our Office also performed external audits covering two of the largest lenders. We reported problems concerning DRG Funding Corporation on January 28, 1988, and recommended to the former Assistant Secretary for Housing that DRG be precluded from making any additional loan commitments until they correct their underwriting weaknesses.

At the time of our report, 79 of DRG's 272 coinsured loans (29 percent) were in default. DRG's defaulted loans amounted to nearly $538 million, or 77 percent of all defaulted coinsured loans.

DRG management practices disregarded HUD's underwriting requirements contributing to its high default rate. The practice increased both its own and HUD's risk of loss. For 11 loans on which DRG had submitted claims at the time of our audit, HUD estimated its eventual loss at about 55 million dollars. More recent data through mid-September 1989 shows that 20 DRG claims were paid or are in process with an estimated loss to HUD of $88 million. Program-wide there were 30 claims submitted with an estimated loss to HUD of $111 million. GAO testified yesterday before this Committee that estimated losses in the Coinsurance Program could approach $960 million.

Unfortunately, the former management team at HUD did not respond to our reports in a positive and timely manner. DRG was not suspended from the Program until March 22, 1989--14 months after our audit and after Secretary Kemp and his team came on board. The Government National Mortgage Association, however, had suspended DRG in September 1988 for failing to make required payments to investors. As you know, the Federal Bureau of Investigation is currently investigating DRG.

A second major effort regarding a coinsurance lender was our audit of Benton Mortgage Company. This audit started in April 1988. We reviewed 14 loans for projects receiving Section 8 Moderate Rehabilitation subsidies and found processing problems with each of them. Our March 20, 1989 audit report discusses deficiencies in Benton Mortgage Company's valuation, mortgage credit and architectural review processing resulting in material misrepresentation of mortgage amounts and rents. We concluded that mortgages totaling $75 million for the 14 projects we reviewed were excessive by $22 million. In addition, excessive Section 8 subsidies of $37 million will be paid for these 14 projects over the 15-year contract periods unless HUD now successfully reduces the contract rents. We recommended that HUD's Mortgagee Review Board take appropriate sanctions against Benton. The Board is currently reviewing this matter.

The Benton audit also pointed up significant weaknesses in the Section 8 Mod Rehab Program. Our April 1989 report on the Mod Rehab Program discusses the lack of adequate cost controls when Mod Rehab projects were coinsured. Essentially, HUD allowed the Coinsurers to establish both the Section 8 rental rates and the insured mortgage amounts with little or no HUD oversight. In response to our audit, the Office of Housing issued revised guidance to HUD staff, PHA's and coinsured lenders in May 1989. These new procedures should address prospectively the problems we noted. However, HUD still faces tough decisions in correcting the problems of overinsured mortgages and excessive Section 8 subsidies for about sixty Mod Rehab projects that were coinsured prior to the implementation of the new procedures.

In a related matter, our Office submitted information to the Department of Justice concerning Benton Mortgage Company's activities and an investigation is in process.

In summary, Mr. Chairman, our experience with the program has been rather extensive and our findings were fairly consistent over the years.

Mr. Chairman, our Office is encouraged by the recent actions taken by Secretary Kemp to enforce HUD requirements on the one hand, while taking a hard look at the program's design. We are working with Assistant Secretary Fitts and her staff to effect needed changes.

This concludes my remarks and I appreciate your attention.

SECTION 223(f) COINSURANCE PROGRAM

Excerpted from the Office of Inspector General Report to the Congress for the 6-month period October 1, 1985 through March 31, 1986, p.25

Coinsurance Program

Lender underwriting practices in the Section 223(f) Coinsurance Program did not fully comply with HUD regulations and HUD monitoring was not always adequate to protect HUD interests. Property values and project net income estimated by lenders consistently exceeded supportable market values. Lender estimates of value and net income for eight projects reviewed exceeded our estimates by $42.4 million and $5.2 million, respectively. We estimate that the coinsured loan amounts exceeded the maximum mortgage amounts by $35.9 million. Although HUD monitoring effectively disclosed such unacceptable lender underwriting practices, it was not effective in assuring that lenders complied with HUD requirements.

Lenders requested endorsement for loans that included costs for repairs that were incomplete at loan closing. Seven of eight projects reviewed had $9.6 million in required or proposed repairs that were incomplete at loan endorsement. Lenders did not have adequate procedures to ensure that repairs would be completed on time. Without this assurance, the potential for loss due to delays in achieving sustained occupancy increases HUD's risk.

We recommended that HUD amend appropriate regulations and issue handbook instructions to assure that HUD's interests are adequately protected. (Audit Report No. 86-TS-112-0004.)

DRG FUNDING CORPORATION COINSURANCE ACTIVITIES

Excerpted from the Office of Inspector General Report to the Congress, Number 19, for the 6-month period October 1, 1987 through March 31, 1988, pp.17-18

Past and ongoing audit work in the Section 223(f) Coinsurance Program and a program monitoring review disclosed that DRG Funding Corporation (DRG), a HUD-approved coinsurance lender, is not complying with HUD requirements. DRG approved unsound loans, failed to detect indications of troubled loans, and was not aggressive or timely in minimizing defaults and coinsurance losses. As a result, DRG jeopardized its sound capital resources and failed to reduce coinsurance losses.

As of September 30, 1987, 34, or nearly 12 percent, of DRG's Section 223(f) coinsured loans were in default. This default rate is very high in comparison to the 0.7 percent default rate of other lenders participating in the program. The outstanding principal balance and accrued interest on DRG's defaulted loans exceeded $253 million. As of April 1, 1988, these numbers had grown to 59, or 20 percent, of DRG's Section 223(f) coinsured loans in default, with a value exceeding $364 million. We believe that this high default rate is a direct consequence of DRG's consistent failure to comply with the intent of HUD loan underwriting and servicing requirements. We previously disclosed deficiencies in DRG's performance in our November 1985 audit report on the Section 223(f) Coinsurance Program. In addition, HUD's Office of Housing issued a monitoring report on DRG in 1987 and reported similar deficiencies in DRG's performance. These reports show that DRG continues to employ high-risk loan processing and management practices in the following areas:

- Valuation Rental and Occupancy Analyses. DRG has not complied with HUD mandates requiring the use of market rents and occupancy ratios when estimating net income. DRG's use of higher-than-market rents and occupancy ratios resulted in overestimated net income which, in turn, justified higher maximum insurable mortgage amounts. Consequently, DRG has increased the probability of defaults and the risk of coinsurance losses.

- Completion of Repairs. Repairs and improvements were not properly inspected before loan closing to assure that the work was actually completed as required. Uncompleted repairs and improvements may preclude the owner from achieving the needed rents or realizing the income necessary to meet expenses and loan payments, thus increasing the risk of default. Also, upon foreclosure, uncompleted improvements may lower the disposition value of a project and increase the coinsurance loss.

- Management Analyses. DRC did not perform underwriting management analyses in accordance with program requirements. As a result, DRC did not identify and correct existing management or operating deficiencies before loan endorsement. The unidentified deficiencies resulted in unsound underwriting and early loan defaults.

- Sound Capital Resources. DRC has not consistently maintained the additional coinsurance net worth requirements pertaining to liquid funds. DRC's cash balance for January, February, and May 1987 was under $500,000 and its receivables consisted primarily of funds due from coinsured projects already in default. In addition, the amounts due from related companies are questionable since HUD is not aware of the financial status of these companies and the potential realization of these receivables.

- Acquisition and Disposition. DRC improperly discontinued foreclosure proceedings on a defaulted loan without curing the default. Rather than accepting a deed-in-lieu of foreclosure and filing a claim for insurance benefits, it allowed title to be transferred twice. By prolonging the default period, DRC will substantially increase HUD's payment for accrued interest and project operating and maintenance expenses for any potential claim it files.

Because DRC has consistently failed to comply with or meet the intent of HUD loan underwriting and has not minimized defaults or insurance loss amounts, we recommended that the Office of Housing take appropriate administrative action to prevent DRC from issuing any further loan commitments until such time as it corrects its underwriting practices and implements effective loan management procedures.

On April 14, 1988, HUD imposed restrictions on DRC's processing and underwriting pending resolution of questions concerning DRC's ability to meet FHA and Government National Mortgage Association capital requirements for continued approval. The restrictions imposed consist primarily of processing and underwriting reviews by HUD of DRC's processing/underwriting of proposed loans, and reviews of proposed issuances of Mortgage-Backed Securities backed by coinsured loans.

SECTION 223(f) COINSURANCE PROGRAM

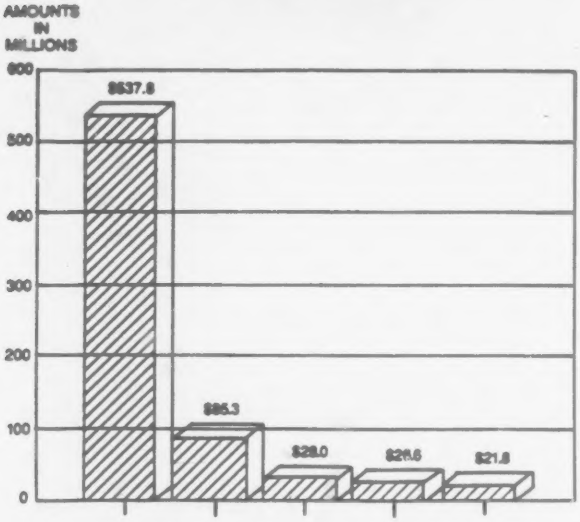
Excerpted from the Office of Inspector General Report to the Congress, Number 20, for the 6-month period April 1, 1988 through September 30, 1988, pp.12-15

We audited the Section 223(f) Coinsurance Program to determine whether lenders were effectively carrying out their delegated responsibilities, and HUD was effectively monitoring and enforcing lenders' compliance with program requirements. The audit focused on three of the 55 lenders participating in the program, ABC Financial Services, Inc. (ABC), DRG Funding Corporation (DRG), and York Associates (York). Together, DRG and York processed 543 coinsured loans, or about 66 percent of all Section 223(f) coinsured loans underwritten as of May 31, 1988. As of that date, participating lenders had underwritten 826 Section 223(f) coinsured mortgages originally valued at about $4.8 billion.

The most serious deficiencies detected during our audit involved DRG. We found that DRG was not adequately complying with HUD's coinsured loan underwriting and servicing requirements. DRG was underwriting unsound loans and failing to detect indications of troubled loans in a timely manner. Additionally, DRG was not taking adequate and timely actions to minimize mortgage defaults and coinsurance losses. HUD's enforcement of program requirements has not been adequate and has not ensured the prompt and effective correction of lender deficiencies.

As of May 31, 1988, 106, or 12.8 percent of all coinsured mortgages, had defaulted. This compares with a default rate of 0.5 percent in HUD's Full Insurance Program as of July 31, 1988. However, the program default rate would be about 5 percent if DRG's program activity were excluded. The outstanding principal and accrued interest balance on the 106 defaulted mortgages amounted to nearly $700 million. As of September 7, 1988, insurance claims had been submitted to HUD for 21 defaulted loans and will require an estimated payment by HUD of about $61.4 million. DRG's financial difficulty compared to other lenders participating in the program is illustrated in the chart on the following page.

Section 223(f) Coinsurance Program
Principal and Accrued Interest Outstanding
Loans in Default By Lender
As of May 31, 1988



	DRG	YORK	GMAC	DENTON	SOUTHWEST
PRINCIPAL	$511.8	$80.2	$27.8	$26.2	$21.5
INTEREST	26.0	5.1	.2	.4	.3
TOTAL	$537.8	$85.3	$28.0	$26.6	$21.8

As shown in the chart above, the principal and accrued interest balance outstanding on DRG's defaulted mortgages totaled nearly $538 million, or about 32 percent of the original value of all of its Section 223(f) coinsured mortgages. Many of DRG's shortcomings were previously identified by HUD's Coinsurance Division and our office through earlier reviews. However, we found during the current audit that these shortcomings had not been adequately addressed by the lender.

In addition, HUD is currently attempting to eliminate the overmortgaging of properties by coinsuring lenders. But, while HUD has authority to suspend or terminate a lender for departing from approved procedures, it had not taken such actions at the time of our audit. HUD has also been reluctant to exercise its authority to suspend or terminate lenders for serious infractions due to the potential adverse impacts such sanctions may have upon the lenders' financial positions and the Coinsurance Program. Rather than implement strict program enforcement measures, HUD has relied on its internal monitoring of lenders to detect problem areas and to achieve cooperation from lenders in correcting such problems. However, HUD's monitoring effort cannot be successful without the application of program enforcement measures.

In our draft report, we recommended that HUD revise its regulations and instructions in a number of specific areas to better protect the Department's financial interests and to ensure the fiscal soundness of the Section 223(f) Coinsurance Program. Since the completion of our audit, the Government National Mortgage Association has terminated DRG's participation in the Mortgage-Backed Securities Program which in effect eliminates DRG from the Coinsurance Program. Management from the Office of Housing is currently reviewing our draft audit report and has not yet responded to our proposed recommendations.

SECTION 223(f) COINSURANCE PROGRAM

Excerpted from the Office of Inspector General Report to the Congress, Number 21, for the 6-month period October, 1988 through March 31, 1989, pp.13-14.

On December 9, 1988, we issued the audit report on the Section 223(f) Coinsurance Program. The audit focused on 3 of the 55 lenders participating in the program: ABC Financial Services, Inc., DRG Funding Corporation, and York Associates. Together, DRG and York had processed about 66 percent of all Section 223(f) coinsured loans underwritten at the time of our audit. As of about February 1989, approved lenders had underwritten about $6.7 billion of Section 223(f) coinsured loans.

Section 223(f) of the National Housing Act authorizes HUD to insure mortgages executed for the purchase or refinancing of existing multifamily housing projects. Section 244 of that Act authorizes HUD to coinsure such mortgages pursuant to a contract with an approved coinsuring lender. Once approved by HUD, the coinsuring lender must agree to abide by all applicable requirements imposed by HUD and agree to perform all of HUD's normal loan underwriting functions, among other functions. The lender bears the first 5 percent of each loss on loans it originates. Any further losses are split 85 percent and 15 percent between HUD and the lender, respectively.

Our audit disclosed that coinsuring lenders were not adequately complying with HUD's coinsured loan underwriting and servicing requirements. Lenders were underwriting unsound loans, overmortgaging properties, failing to detect indications of troubled loans in a timely manner, and were not taking adequate and timely actions to minimize mortgage defaults and coinsurance losses. At the time of our audit, 106, or nearly 13 percent of all Section 223(f) coinsured loans, had defaulted. The outstanding principal and accrued interest balance applicable to the 106 loans amounted to nearly $700 million.

While HUD has taken aggressive actions to improve its monitoring of coinsuring lenders' performance, more effective controls and enforcement efforts are needed to enhance the Department's capacity to achieve corrective action by lenders in a more timely manner. HUD's failure to enforce program requirements in a more vigorous fashion is adversely affecting the success of the Section 223(f) Coinsurance Program in preserving existing rental housing and in ensuring the timeliness and quality of lenders' loan underwriting. HUD is also incurring substantial losses in the program and will continue to do so in the future unless more aggressive enforcement measures are taken. These internal control weaknesses are material and were reported as such under the Federal Managers' Financial Integrity Act in the December 31, 1988 report to the President. They should be again reported in the December 31, 1989 report.

The most serious deficiencies detected during our audit of the Section 223(f) Coinsurance Program involved DRG Funding Corporation. At the time of our audit, 79, or 29 percent of DRG's 272 coinsured loans were in default, encompassing nearly 32 percent of the original value of its Section 223(f) coinsured mortgages. The outstanding principal and accrued interest balance on DRG's defaulted loans amounted to nearly $538 million, or about 77 percent of the total principal and accrued interest balance outstanding on all defaulted Section 223(f) coinsured loans at the time of our audit.

Our audit disclosed that DRG was employing high-risk loan processing and management practices in almost every phase of its operations. Consequently, DRG's disregard of HUD's underwriting requirements contributed to its high default rate and substantially increased both its own and HUD's coinsurance risk. For just 11 loans for which DRG had submitted claims to HUD at September 1988, about $55 million in claim payments will be required by the Department. HUD estimated that its losses from DRG loans could be in the hundreds of millions.

In September 1988, the Government National Mortgage Association (GNMA) terminated DRG's participation in the Mortgage-Backed Securities Program, declaring that DRG was in default of its obligations as an approved issuer because DRG failed to pass sales proceeds from disposed projects to GNMA security holders. GNMA was reportedly spending over $6 million monthly to cover the shortfall in debt service payments to GNMA security holders. About $1.1 billion of DRG's Section 223(f) loans were acquired by GNMA and assigned to another lender for servicing.

On January 23, 1989, the FBI executed a court-approved search warrant on DRG. The search warrant application alleged that DRG committed fraud and other offenses against the Federal Government under the Section 223(f) Coinsurance Program and GNMA Mortgage-Backed Securities Program. Documents filed with the court alleged that DRG disregarded HUD regulations, underwrote loans for amounts in excess of the market value of the underlying properties, sold foreclosed properties for substantially less than their value, failed to pass sales proceeds from disposed properties to GNMA security holders, made false statements and certifications to HUD, and misapplied escrow funds. The FBI's investigation of DRG is continuing.

On March 22, 1989, HUD announced that DRG, its affiliates, and 17 named officers/employees were suspended from participating in all Federal housing programs or procurement contracts. The suspension was the result of DRG's irregularities in dealing with GNMA and the Federal Housing Administration as well as allegations of criminal activities, as evidenced by the FBI's investigation of the lender.

On March 31, 1989, the United States District Court for the District of Columbia denied a claim DRG made previously against HUD and dismissed DRG's civil action. On August 5, 1988, DRG had filed a lawsuit against HUD disputing the manner in which coinsurance benefits were paid by HUD. DRG sought a declaration that it was entitled to receive its debentures (coinsurance benefits) with interest from the date of default rather than from the date of settlement of insurance claims. At stake was between $8 million and $9 million in additional interest payments for nine loan claims by DRG.

In addition to the actions taken against DRG, HUD proposed numerous other actions during the reporting period in response to our Section 223(f) report recommendations. For example, HUD proposed to: (1) more vigorously enforce the current regulatory timeframe for acquiring projects after default; (2) publish regulations to revise the amount of accrued interest payable for the period between acquisition and disposition; (3) implement measures providing for financial disincentives for lenders' unsound underwriting and other types of lender noncompliance with program requirements; (4) increase lenders' sound capital resources and liquidity requirements; (5) require lenders to establish and maintain dedicated, funded accounts to accommodate coinsurance losses; (6) publish a policy setting forth the administrative remedies and sanctions HUD will invoke against coinsuring lenders for serious infractions of the Department's coinsurance requirements; and (7) implement a procedure for reviewing lenders' underwriting and property disposition when property sales are below a stated percentage. (Audit Report No. 89-TS-119-0002.)

BENTON MORTGAGE COMPANY

Excerpted from the Report on Benton Mortgage Company, Knoxville, Tennessee, HUD-Approved Coinsurance Lender, Number 89-TS-221-1005, March 20, 1989, pp.i-ii

EXECUTIVE SUMMARY

We examined the books and records of Benton Mortgage Company (BMC), Knoxville, Tennessee, pertaining to its multifamily coinsurance lending activities for assisted projects. The purpose of our examination was to determine if BMC adequately processed Section 221(d) and 223(f) coinsured loans with Section 8 Moderate Rehabilitation assistance.

BMC did not follow prudent underwriting practices and HUD requirements in 14 out of 14 loans tested. Deficiencies in BMC's valuation, mortgage credit and architectural processing resulted in material misrepresentation of mortgage amounts and rents. Since HUD's Section 8 subsidy funds the amount of any excess rent, the deficiencies will seriously impact Section 8 funds. Deficiencies included the following practices.

Valuation Processing

BMC:

- o Substituted superior comparables for those used by BMC's contract appraiser resulting in higher Section 8 rents and a correspondingly higher mortgage.
- o Increased rents with excessive and/or unwarranted rent trend adjustments, often when vacancies were high and rents had declined.
- o Increased rents by misstating data on either the subject or comparable properties to minimize adjustments.
- o Selected their subject rents from the upper range of comparable rents without justification.
- o Increased without justification their contract/staff appraiser's appraised values and thus the replacement cost mortgages, to be consistent with higher debt service mortgages.
- o Processed a project under the wrong program, allowing the developers the maximum mortgage they sought.
- o Treated property purchases as refinancings to justify higher mortgages.

Architectural and Mortgage Credit

BMC:

- o Approved construction contract increases long after added work was completed, and for work already included in the contracts.

- Allowed mortgagors to use vague work descriptions and specifications, weakening BMC controls over costs and the quality of repair work.

- Allowed mortgagors to inflate profits through "paper conduit" general contractors.

- Did not deduct excessive costs from mortgagor cost certifications, e.g., capital improvements funded with rental income, management fees for services performed by the PHAs, and tax credit application fees.

Also, BMC issued a commitment to a mortgagor having a family relationship with the owners of BMC without seeking Headquarters approval.

BMC's noncompliance with HUD requirements and less than prudent underwriting practices inflated mortgages and rents, and will result in excessive Section 8 subsidy. Mortgages for the 14 projects reviewed were excessive by an estimated $22 million, or 29 percent, and Section 8 subsidy will be overpaid by an estimated $37 million over the 15 year life of the Housing Assistance Payment (HAP) contracts. We established the excessive mortgages and rents through reappraisals by eight HUD appraisers working independently. The 14 projects were scattered in 5 HUD regions.

BMC allowed mortgagors to include excessive costs in Section 221(d) mortgages, which inflate the Section 8 rents and HUD's subsidy costs. Excessive profit allowances, improperly approved increases to construction contracts, and ineligible costs have or will result in the ten mortgages reviewed being overinsured by approximately $2.3 million. Our review does not include ineligible costs identified in separate audits of mortgagor and contractor records.

Based on BMC's deficient underwriting we are recommending that the Mortgagee Review Board take appropriate sanctions against BMC.

The findings were discussed with BMC officials and staff during the audit and at an exit conference held January 12, 1989. Subsequently, BMC provided detailed written comments to our draft audit report. We summarized the comments as we deemed appropriate after each finding and in various sections of Appendix B. The entire 53 page response is being maintained in our audit workpaper files. Later, on March 10, 1989, BMC provided a supplementary response and requested that for report purposes the second more general response be included verbatim in the report (See Appendix G).

The **Chairman**. You have made a number of very troubling observations about your findings. Let me call on Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

Mr. Adams, I would like to get some further detail about the specifics of the coinsurance program. There were some aspects of coinsurance in which I am curious to determine whether they were a matter of statute, regulation, or departmental practice.

Apparently, the standard coinsurance loan was a nonrecourse loan. Is that a correct statement?

COINSURANCE PROGRAM

Mr. **Adams**. I believe that is correct, sir.

Senator **Graham**. What was the derivation of the decision to have these mortgages be nonrecourse?

Mr. **Greer**. Senator Graham, most FHA mortgages are nonrecourse, so the coinsurance aspect had little or no effect on that. FHA from the beginning has had nonrecourse loans.

Senator **Graham**. And what is the derivation of that decision?

Mr. **Greer**. I am not really certain. It goes way back in time, though.

Senator **Graham**. Other than history, is there any policy rationale to that?

Mr. **Adams**. We are not aware of that. We will check and submit it for the record, if we could, Senator Graham.

[The following information was subsequently submitted for the record:]

Question. And what is the derivation of that decision? Other than history, is there any policy rationale to that?

Answer. Originally, FHA could not find enough developers interested in participating in its programs because of the red tape involved and because its programs were oriented toward low-income households. FHA, therefore, decided to make its insured loans nonrecourse. In addition, FHA recognized that project developers established corporate enterprises to own and manage the projects. As such, FHA was unable to go after the assets of the principals involved once the corporations went out of existence unless, of course, fraud was involved.

Senator **Graham**. What was the derivation of the decision that by granting coinsurance status there would also be a delegation of the determination of fair market rents?

Mr. **Greer**. The derivation is simply a carry-forward from—prior to the coinsurance program, which began in 1983. If a Mod Rehab project was in fact going to be an insured project, an FHA insured project, then the HUD area office underwrote the loan and established the rental rates at a level they figured was sufficient to carry the debt service and make the payments on the mortgage, and also operate the project in an efficient manner.

When coinsurance came into being, that policy was not revised in any way, and it just carried forward into the coinsurance program. The lenders generally just sat in the HUD area offices' place and did all of the processing, established the rents. HUD area office officials were supposed to approve those rents; but as we point out in our audit, that did not always occur.

Senator **Graham**. Third, the decision to give to the coinsurer the primary responsibility for deciding what would be the extent, the scale of the mortgage. Was that also——

Mr. Greer. That was a furtherance of that philosophy, privatization, if you will, that HUD needed to delegate those responsibilties out. They were intending to cut staff and just delegate the whole process, not only multifamily but also in the single family area.

Senator **Graham.** Was there any concern about the conflict of interest that was created by putting the same entity which is going to have a financial stake in the size of the mortgage and the security of the rent behind that mortgage in the position of deciding how large the mortgage and the rents would be?

Mr. **Greer.** We are not sure how much consideration was given to that, but we did criticize that in our report. That situation has now been rectified, in that HUD will now underwrite the mortgage—I mean, establish the rental rates. During the course of our audit period, that was not done. The coinsurer was pretty much at liberty to do whatever it wanted.

There was a requirement that HUD area office people approve the rents if the units exceeded 50; but again, during our audit, we noted that the HUD area offices were not very diligent in doing that.

Senator **Graham.** Within HUD, what was the form in which these kinds of questions could have been raised?

Mr. **Adams.** That would have been a policy deliberation, Senator, and I am not sure that we were privileged to that.

Senator **Graham.** It was not established under an open process, such as the promulgation of a rule that would have initiated public discussion prior to final agency action?

Mr. **Greer.** That is correct. It was not. The policy evolved over a period of time. In order to correct that problem, rules are now being written by the housing staff, and they hope to have something in clearance within a month or so.

Senator **Graham.** You indicated that, as early as the fall of 1984, you were bringing to the attention of HUD management your concerns as to how the coinsurance program was being operated?

Mr. **Adams.** That is correct, sir.

Senator **Graham.** In what form did you bring those concerns to the attention of HUD management?

Mr. **Adams.** That was in the form of a memorandum from Mr. Greer's predecessor to the Assistant Secretary for Housing, as I recall. Is that correct, Mr. Greer?

Mr. **Greer.** Yes.

Senator **Graham.** And you characterize the response to that as being one of denial?

Mr. **Greer.** At that time, there was very limited experience with the program. There had been no defaults at the time. They thought we were overly critical and that the things that we had recommended at that time probably would have short-circuited, if you will, the program. In other words, the lenders may not participate in the program if the controls are too stringent; that was their basic reason for not implementing the exact recommendations that we had made.

It is very difficult to push a point, when in fact there had been no defaults at the time.

Senator **Graham.** My time has expired, Mr. Chairman.

The **Chairman.** Senator Pressler.

Senator **Pressler**. I have no questions for this panel. I do think that it is very disturbing news that was reported to us yesterday concerning the FHA, and I am hopeful we can take steps to turn this around in the near future.

I may have some questions for the record for these witnesses.

The **Chairman**. Very good. Why don't we continue with that line of questioning, Senator Graham.

Senator **Graham**. When was your next report issued to HUD management?

Mr. **Adams**. December 1988.

Senator **Graham**. And could you elaborate on what response occurred at that report?

DECEMBER 1988 AUDIT REPORT

Mr. **Greer**. You have to divide that into two segments. The former Assistant Secretary responded——

Senator **Graham**. Who was the former Assistant Secretary?

Mr. **Greer**. Tom Demery. He responded in much the same manner as the first one, in saying that they will in fact improve their monitoring capabilities, but that they really did not want to consider any major structural changes to the program at that time.

Subsequently, the new management team at HUD took a second look at the recommendations and also at the program, and came back with what we consider to be a very positive response. As I mentioned earlier, they are in the process of making some major changes to the design and structure of the program itself.

Senator **Graham**. Since your report in December 1988, in addition to the initiation of action that may lead toward some rules changes, have there been any other changes in the program? Have any lenders been decertified or in other ways terminated or restricted in their participation? Have there been changes in how rents and mortgage levels are established?

Mr. **Greer**. There are wholesale changes. I will answer the last part of the question first. The manner in which the Mod Rehab projects are going to be handled is materially different than it was during our audit period. HUD people will be involved early on in establishing the rental rates.

Senator **Graham**. You are using the future tense, "will be involved." I am interested in as of today. In what ways is the program different than it was in December 1988?

Mr. **Greer**. I said "will be" because, starting in May, they put a probation sanction on many of the lenders. The actual memorandum I believe went out on May 5, describing the procedures that I just said, that the HUD office will be directly involved in establishing the rents. That was effective some time in mid-May of this year.

To answer the first part of your question, there are probably eight or nine lenders that have been sanctioned, so called. Either they have been placed on probation, which means that the lender cannot make a firm commitment until HUD has reviewed the package. There are three or four other lenders that have been put on what is called a post-endorsement review, which means that every loan that they write will be looked at rather closely; but after endorsement, not before endorsement.

Senator GRAHAM. How were firms such as DRG and Benton selected to be the participating coinsurers under this program?

Mr. GREER. That is a proactive process. Any lender that wanted to participate in the program applied to the Department and went through a lender approval process. They had to show that they had the capital resources and meet the other requirements of the lender approval handbooks.

Senator GRAHAM. I assume that, since HUD was going to delegate to the coinsurer the authority to essentially set mortgage levels and establish what fair market rents were, that the agency was concerned about the experience, expertise, track record of those lenders in carrying out those managerial functions?

Mr. GREER. Yes. All those things that you mentioned are part of the criteria that are established to measure the lender's ability to continue, yes.

Mr. ADAMS. I might add, Senator Graham, that the Department would review at least the three initial applications submitted on that program, to determine whether or not they had performed adequately on those, as part of the approval process also.

Senator GRAHAM. Have you reviewed the process by which applicants for participation as coinsurers were evaluated and the initial judgment made? Did DRG and Benton, to use those two examples, have in their files evidence that would have led one to believe that they were competent to carry out these functions?

Mr. GREER. Yes, sir. When we did the audits of both DRG and Benton, we did look at their files, and they certainly met the requirements.

Senator GRAHAM. If they met the requirements at the time of application, and unless you indicate otherwise, the review of their first three cases was competently done. To what would you attribute the fact that the subsequent history of these two firms has been so dismal?

Mr. GREER. That is very difficult to say; but when we did our audits we found in both situations, both DRG to a very large extent, and Benton to a lesser extent, that they did not comply with the underwriting requirements that HUD had laid out. They had the experience, they had the capital requirements in place; they simply did not do prudent underwriting. That is basically what we said in both of our audits.

Senator GRAHAM. Were the professionals who were making these judgments during the period that this pattern of failure was being accumulated the same people, more or less, as those who were in the firms at the time that they were initially brought into the program?

Mr. GREER. For Benton, I can say positively it was the same people. I think there were some changes within the structure at DRG, but I am not really sure when those took place.

Senator GRAHAM. Do you have any indication of the relationship between officials within HUD and officials at Benton or at DRG, that may have affected the judgment of Benton and DRG in terms of setting mortgage amounts and rent levels?

Mr. **Greer**. There are a couple of situations. For example former Assistant Secretary Demery was what is called a cobroker for DRG back in the early 1980's, before DRG was a coinsured lender. But he did cobroker loans for that company prior to his employment at HUD, either as a contractor or as the Assistant Secretary.

In a similar manner, there are former HUD employees currently employed by Benton Mortgage Co., and there are also former HUD employees that are corresponding brokers with Benton. In other words, people that do a lot of the processing and get about 1 percent of the fee. It is a fee of 1 percent of the mortgage amount for doing that work, which is permissible under HUD guidelines.

The **Chairman**. That also means, I take it, that the higher the mortgage, the higher the fee. Correct?

Mr. **Greer**. That is correct.

Senator **Graham**. And the higher the rents, the higher the mortgage, and the greater the assurance of ability to repay the mortgage.

Mr. **Greer**. That is correct.

Senator **Graham**. So the coinsurer had multiple reasons to want to inflate both the mortgage and the fair market rents.

Mr. **Greer**. Yes.

Senator **Graham**. The Federal Government was essentially the insurer of last resort, and the payor of last resort behind the mortgage and the rents.

Mr. **Greer**. Yes, sir. Most coinsured loans and all of those in the Mod Rehab Program were backed by Ginnie Mae certificates. So the Federal Government is there in one way or another, 100 percent.

Senator **Graham**. Although on paper the mortgages have shared responsibility between the private insurance firm and the Federal Government, in reality the Federal Government has 100 percent of the ultimate risk. Is that correct?

Mr. **Greer**. It is, if the lender does not opt to pay his share of any losses, yes, sir.

Senator **Graham**. I would like to use that response to bridge to the next questions. That is, the capital requirements behind the lenders which were the safety margin for the Federal Government in terms of the ability of the insured, if called upon, to meet their obligations.

Have you looked at the capital requirements?

CAPITAL REQUIREMENTS

Mr. **Greer**. Yes, sir. In both of our audits we suggested that those be ratcheted up quite a bit.

Senator **Graham**. What were the capital requirements during the period 1984 to 1988?

Mr. **Greer**. I believe it is $1.5 million, of which $500,000 has to be in a form that is fairly liquid, and then a certain percentage, I think it is 3 percent, of the volume underwritten.

Senator **Graham**. So the formula is, your capital requirements must be $1.5 million, plus 3 percent of the mortgages insured?

Mr. **Greer**. It is $1 for every $300 of mortgage amount. I am sorry.

Senator GRAHAM. So it would be $1—that would be one-third of 1 percent?

Mr. GREER. Yes.

Senator GRAHAM. Who determined those levels of capital as being adequate?

Mr. GREER. That was a call made by the Office of Housing when the program was being designed, I presume.

Senator GRAHAM. What year was that level established?

Mr. GREER. Probably 1982, 1983, somewhere in that area.

Senator GRAHAM. And again, was there any public comment on that decision?

Mr. GREER. I cannot say for certain, but I would be surprised if that was not included in regulations that were published and commented on.

The CHAIRMAN. Would you check that for the record and provide it?

Mr. GREER. Yes, sir.

[The following information was subsequently submitted for the record:]

Question. Would you check that for the record and provide it?

Answer. A "Sound Capital Resources" requirement with respect to coinsurance was first added by an interim rule [March 31, 1982–47 FR 13517] revising the 24 CFR Part 255 coinsurance program for existing multifamily projects.

There was one public comment on the Sound Capital Resources provision in this rule. It was technical in nature, relating to loss reserves, and was discussed by HUD in a subsequent interim rule dated May 25, 1983 [48 FR 23386]. A final rule on Part 255 was published on June 24, 1985 [50 FR 25915]. In that rule and in subsequent revisions to it there have been no substantive changes in the Sound Capital Resources Provisions.

On March 9, 1984, a proposed rule was published [49 FR 9084] which would establish [at 24 CFR Part 251] a coinsurance program for newly constructed or substantially rehabilitated multifamily projects. It contained the same Sound Capital Resources requirements as are found in the Part 255 program.

A final rule was published on August 9, 1984 [49 FR 32016]. It contained no public comments on the Sound Capital Resource provision in the proposed rule.

Subsequent revisions to Part 251 make no significant changes in the Sound Capital Resources Requirement.

On December 31, 1987, the Department published a proposed rule which would establish a new coinsurance program for nursing homes. The rule proposed more stringent Sound Capital Resources requirements than apply in the Parts 251 and 255 programs mentioned above. On August 3, 1988 at 53 FR 33724, a final rule was published. It provides for even more stringent Sound Capital Resource requirements. Discussion of the public comments and HUD's reasons for more stringent requirements can be found at pages 33726 and 33731 of the rule.

Senator GRAHAM. Did HUD monitor the fact that those capital standards were in fact being met, as for instance a DRG or Benton increased its number of insured mortgages, that it was increasing its capitalization by the one-third of 1 percent required?

Mr. GREER. On an annual basis, the lender was required to have an audit by a CPA firm, and that audit submitted to HUD. HUD has staff that reviews those reports.

Senator GRAHAM. Was it your finding these capital requirements were being maintained?

Mr. GREER. Yes, sir. In both situations, we believe that, at least for most of our experience with DRG, that it was met. I think that they ran into problems in late 1987 or 1988, and that really began their downfall, when they could not meet the net worth requirements. As far as Benton goes, I am quite certain that they have always met the net worth requirements.

Senator **Graham**. Have there been any changes in these capital requirements since December 1988?

Mr. **Greer**. That is one of the things that the Office of Housing is currently considering. My information is that they are going to change those considerably, but I do not know the specific details yet.

Senator **Graham**. It seems to me incredible that situations like this, that are so clearly deficient, have taken 9 months—that it takes 9 months to lead to the statement that the capital is inadequate and that it should be increased. Is there some reason why it has been so ponderous to get a simple decision like this made?

Mr. **Adams**. I think it is part of the overall consideration of the restructuring of the entire program, Mr. Graham.

Senator **Graham**. My feeling is, if the patient is in the emergency room and bleeding to death, and also has lots of broken bones, then you had better stop the hemorrhaging first and then you can put a splint on the arm an hour later.

I think we need to start putting some tourniquets on these bleeding areas, such as the grossly inadequate capital requirement which puts the Federal Government at a higher level of jeopardy and risk, and as your report indicates maybe up into the billions of dollars of Federal obligation because of these failed coinsurance firms and schemes.

That is the end of my editorial comments.

The **Chairman**. But you nodded in the affirmative, unless my eyes are going bad. Did you agree with his comments, Mr. Adams?

Mr. **Adams**. I share his concern that we also for instance have some concern about the single family mortgages and their capitalization also, the net worth requirements. We feel strongly that there should be some correlation between the volume of business they do and the capitalization.

The **Chairman**. Do we have a problem in single family, in the sense that it is the counterpart of the problem in the Mod Rehab area here?

Mr. **Adams**. I do not think it is necessarily of the same magnitude. We did do a study last year, and we looked at the single family program, and we made some recommendations. A lot of actions have already been taken, but we think some additional things should be done.

One of those recommendations that we made was that they should relook the net worth requirements for single family lenders. We found some instances in which a lender had originated some bad mortgages and was causing defaults. They found it advantageous to go out of business, and they had nothing for the Government to attach to recover moneys.

The **Chairman**. Senator Graham has said this before. Every time we open one door and clean through the wreckage, we find other doors that lead in new directions.

I take it from what you are saying that we have a coinsurance problem in single family as well?

DIRECT ENDORSEMENT

Mr. ADAMS. No, not coinsurance.

Mr. GREER. It is not coinsurance, it is delegated processing called direct endorsement; but it is similar in nature.

The CHAIRMAN. So the direct endorsement program, the inference is that there are large potential dollar losses in that area as well?

Mr. GREER. Yes, sir.

The CHAIRMAN. What kind of rough magnitude are we talking about?

Mr. GREER. As GAO testified yesterday, there have been some adjustments to the loan loss reserves. Part of that in the MMI is attributable to single family as well as multifamily.

The CHAIRMAN. Do you have any sense for the dollars?

Mr. GREER. Their adjustment was like $1 billion, if I remember right.

The CHAIRMAN. Just one other thing. In terms of the size, of the dollar loss, that you are putting on the coinsurance under Mod Rehab, what is your best estimate as to that figure now?

Mr. GREER. We are not attributing any direct loss. We had the coinsured loans. Those loans, as Senator Graham pointed out, the Federal Government is paying the rent, so those loans should not go into default. So there should not be any losses attributed to coinsurance and Mod Rehab, when the two are coupled together.

Senator GRAHAM. I guess you might say that, instead of the Federal Government providing the bail-out directly through failed projects, we are providing it indirectly through inflated rents.

Mr. GREER. Yes, sir. That is what we reported in our audit report. The Department is now faced with some difficult decisions on whether they are going to reduce the rents, as we are commending, because that is going to have a material impact on the insurance fund, because that probably would create a default for the mortgagor.

Senator GRAHAM. I am now going to succumb to my temptation to editorialize again, and this time editorializing the past. Our previous hearing was on the section 8 Mod Rehab, and particularly how fair market rents were established.

As one of you gentlemen alluded to in describing the process by which lenders were selected, their expertise in setting rents, the fair market rent concept in my opinion has been severely perverted in this program. It has been converted essentially into a public utility process, where you attempt to add up all of the costs that have to be covered, and then have a rent high enough to cover those, even if that rent has no relationship to what in fact rents in the particular neighborhood for equivalent units are that are being received in the private marketplace.

I believe that a fundamental reform of this program is going to be to go back to what is the common sense definition of fair market rents, and leave this artificial system that we are currently using which, among other problems, creates this tremendous opportunity for abusive, excessive rents that we are currently seeing played out through the role of coinsurers.

I would like to talk some more about the degree of monitoring that HUD had of these various steps. What was the relationship at the local field office level, during the period 1984 to 1988, between a designated coinsurer, the developer, and the HUD professional staff?

Mr. GREER. Are you referring now to the Mod Rehab Program?

Senator GRAHAM. In terms of setting the amount of the mortgage and the rents.

Mr. GREER. About the only relationship that the HUD area office had at that time, to the best of my knowledge, is that they were required to approve the rental rates established either by the PHA or the coinsuring lender. Other than that, everything was delegated to the coinsuring lender.

Senator GRAHAM. What in fact did the typical field office do in that responsibility of reviewing the rent rates that the coinsurer was recommending? Do you have any examples of where the local field office challenged rents that were recommended by the coinsurer? And, if so, what happened to that challenge?

Mr. GREER. There were a few instances in those 14 projects that we looked at that the HUD area office questioned the level of the processing rents set by the coinsurer. One I can think of is in Baltimore, MD, a project called Kingsley Park, where the PHA then obtained a waiver for the need for the HUD area office to approve those rents and allowed that project to be processed at the maximum—at the fair market rent, rather than what the actual market rents are. There is always confusion between fair market rents and actual market rents.

I believe there was a second one, but I cannot recall the exact name of that right now, where the waiver was granted to allow the processing at the 120 percent of the Mod Rehab market rent.

Senator GRAHAM. You mentioned in the one example in Baltimore that a waiver had been applied for. Was that a common practice within this program of coinsurers, providing for fair market rents which then required a waiver of the normal ceiling on rents?

Mr. GREER. In the coinsurance program, no, sir. What we point out in our Benton audit report and in our national Mod Rehab report is that the large majority of units were subsidized at the maximum, the FMR, which is the ceiling rent, within $1 or $2 of those rents, in 70 to 80 percent of the cases. So there was little need to get a waiver. Rents were established and often approved by the area office at the levels that they wanted.

Senator GRAHAM. In our previous discussion of how section 8 units and Mod Rehab applications were distributed, there was a pattern of favoritism for certain firms where selected expediters in Washington were able to get favorable treatment. Was there any pattern that you can discern of expediters being used, either at the time that a mortgage insurance company was making a financial application to become selected to participate in the program, or in the processing of individual applications such as the request for waiver in the Baltimore project?

Mr. ADAMS. I have no knowledge of any lobbyists or others.

Do you, Mr. Greer?

Mr. GREER. No.

Mr. ADAMS. On the second issue——

WAIVERS

Mr. **Greer**. On the issue of waivers, there may be some isolated cases where some of the folks that have been in the news were in fact also involved in obtaining waivers. The one I can think of specifically is an attorney by the name of Linda Murphy, who was sometimes involved in obtaining—writing the requests for the waivers. That is not to say that she had any influence over the actual approval of it; but she was involved in obtaining the request.

The **Chairman**. If I may ask, are there any other names that you can identify?

Mr. **Greer**. No, sir.

The **Chairman**. Are there others that are just not coming to mind? You said that you saw some.

Mr. **Greer**. That is about the extent of the knowledge that I have, and we only looked at Benton Mortgage Co.

The **Chairman**. So if we were to ask you to take a broader look, and go back—I am very much interested, as I know Senator Graham is, in finding out who these facilitators might have been. Because it seems like there is a very pervasive pattern of various kinds of intervention. I would like to get some of those people in here and ask them directly, so that you are not in the awkward spot of trying to explain what they may or may not have done.

But I think we need your help in more clearly understanding who these people are, in addition to the Ms. Murphy that you just mentioned. So, I would like you to take a look at that, and see if you can help highlight some of the other persons who may have operated in the same fashion.

Mr. **Greer**. We will attempt to do that. It is difficult to identify the origin of a request.

The **Chairman**. You were able to do it in her case.

Mr. **Greer**. Yes.

The **Chairman**. You may be able to do it in others. You looked at Benton and that is where you found this.

Mr. **Greer**. That is because we knew she was associated with the Benton Mortgage Co.

The **Chairman**. You have been working hard on this. I would like you to press a little harder.

Mr. **Greer**. We will.

[The information referred to follows:]

We reviewed documentation supporting 20 processing waivers for multifamily co-insured moderate rehabilitation projects. We contacted the requestor to determine if facilitators were used in the preparation of the waiver documents. Twelve of the 20 requests were made by the co-insured lender, Benton Mortgage. Because of the ongoing Benton investigation and the pending Mortgagee Review Board action, we did not interview Ms. Murphy or follow-up with HUD officials responding to these specific waivers.

For the remaining eight waivers, we were able to make contact with seven of the requesting officials. In one case, Sharon K. Shore acted as a contract agent in obtaining a waiver for occupancy requirements for the Delmar Apartments project, Gillette, Wyoming. Facilitators were not used for the remaining six waivers.

Four of the seven respondents noted that the project owners/developers were instrumental in the preparation of the waiver request. Specifically, Winn, Abrams, Neilson and Queenan were mentioned as individuals that gave the PHA direction in preparing the requests.

The CHAIRMAN. You have an obligation to see if we can find out who else was involved this way. Thank you.

HUD OVERSIGHT

Senator GRAHAM. We were on the general theme of the level of HUD oversight, either at the central office in Washington, or at a field office of this program. We discussed the oversight relative to the selection of the mortgage companies to participate.

Are you familiar with any mortgage companies that applied to participate and were denied? If so, on what basis?

Mr. ADAMS. I am not aware of any. Maybe Mr. Greer is.

Mr. GREER. I am not. The Office of Housing would have to answer that question, sir.

Senator GRAHAM. Once a mortgage had been granted and the rents established, was there any continuing role of the HUD field office in evaluating whether the rents that had been established continued to be appropriate? There was a provision that allowed the developer to periodically apply for changes in rents; is that correct?

Mr. GREER. There are two methods, at least to my knowledge, that an owner can get a rent increase in. One is simply to apply because his costs are out-stripping his income, and the other is the application of an annual adjustment factor that is there in the section 8 program by regulation.

Senator GRAHAM. Was there any process by which the HUD field office or others could initiate a proposal to reduce the rents, if they found that the rents, based on subsequent activities or information, had either been established at an excessive rate initially, or circumstances rendered them excessive?

Mr. GREER. There is a provision in the contract between the PHA and the owner that allows for reduction of rents on a postaudit basis. That could have happened. I am not aware if it happened often, if it happened at all in the normal course of business. We, of course, have recommended in many of our audits that rents be rolled back to a lower level.

Senator GRAHAM. In your opinion, does HUD have a legal authority to do so?

Mr. GREER. Yes, sir. They have the authority, and they have done it in the past.

Senator GRAHAM. They have done it in the past?

Mr. GREER. Yes, sir.

Senator GRAHAM. Have any rents been reduced since January of this year, to your knowledge?

Mr. GREER. I am not certain. I do not think so. The decisions to reduce rents based on our audits have not been made yet.

Senator GRAHAM. I am now moving to another area. In your audits, you used some fairly specific numbers as to the extent to which you believe excessive rents have been granted. How did you arrive at the number that you felt was an appropriate rent against which you would then evaluate the actual rent that was allowed, to determine excess?

Mr. GREER. That answer requires two sections, I guess. In the coinsured situation, we used the services of HUD appraisers to go out and do a recalculation of the appraisal and the rents. In most cases, we used their figures as the correct figures, and bounced those off the amounts that had been established by the mortgage company.

In the other situation, we simply did audit work to verify whether the costs stated were accurate and eligible in accordance with appendix 34 of the handbook, which is the guidelines for eligible costs in the program. If we found costs to be ineligible, we deducted those and made our own computation after that.

Senator **Graham**. I have a letter which is dated August 10 1987 to the person that you mentioned earlier, Ms. Linda Murphy, from a Mr. James L. Hammernick, I believe, the Director of the Office of Insured Multifamily Housing Development. It relates to a Benton mortgage project, Gardens of Homestead.

In the letter, Mr. Hammernick states:

> Subsequent to the issuance of our instructions to the Jacksonville office, we changed our policy regarding how rents are established on projects involving both the coinsurance and moderate rehabilitation programs.
>
> Our new policy provides that, if the public housing authority computed rents are equal to or less than the fair market rents for section 8 moderate rehabilitation, the coinsured lender may proceed at these rents without regard to market comparability analysis.

In your opinion, is that statement of policy consistent with the statute and the regulation?

Mr. **Greer**. We do not believe it is. There was a whole series of situations where policies were made by memorandum, just like the one you just read, and there was no consistency in those memoranda. That policy has now been changed, and it will be consistent in the future.

Senator **Graham**. Where do you think the origin of a policy change such as stated in this letter would have come? Would Mr. Hammernick, as the Director of the Office of Insured Multifamily Housing Development, have had authority to make that type of policy change?

Mr. **Greer**. He probably does not have the authority.

Senator **Graham**. Based on your——

Mr. **Greer**. I mean, regulation changes are normally done through a comment period, as you mentioned earlier.

Senator **Graham**. Based on your knowledge of the agency, where do you think a change like this would have originated?

Mr. **Greer**. I would think that that would have to be at the assistant secretary level, in most situations.

Senator **Graham**. Senator Wirth?

Senator **Wirth**. No questions.

The **Chairman**. I just might make an observation as we continue. I know that you have to be on the House side. In due course, we will be wrapping up our testimony from you, as we have others waiting also to testify.

But I think Senator Graham has done an excellent job of systematically laying out the manner in which these various program elements interconnect with one another to create a larger and larger potential for abuse, and I think, in fact, a pattern of abuse.

The approach that we are following, in terms of building up from the bottom the way these programs actually were put in place and are supposed to work, and then got off course, I think will lead us in due course, to understand exactly how it was that these programs ended up being abused to the tune of some several billions of dollars, according to the current Secretary of HUD's own estimate.

It is going to take awhile to do that, because it takes a lot of detective work, of which you fellows have made your life, made it a centerpiece in your professional life to do this.

It is very important that we continue to work together to put this puzzle together, so that we find out exactly how the manipulations went on, and how we got off the track, so that we can do two things: One, change the way these programs work and are managed and are legislated, and the rules and everything that governs the conduct of them; and also to find out who it was that made off with all of this money, and to be relentless--and others will be involved in that activity, hopefully the Justice Department, in an aggressive way, to track down people who did improper things, and to recover whatever amount of money can be recovered.

So we will continue to need your very active cooperation with us, as we go through that systematic information base building process, as we build this up to a full knowledge of what happened.

That is going to take awhile, but however long it takes, we are going to continue to do it until we have that picture completely together.

Mr. ADAMS. We appreciate that opportunity, Mr. Chairman, and we will work closely with you and your staff.

Senator GRAHAM. Mr. Adams, I know that you have other obligations, and we are about to start a vote.

On the third page of your statement, you state: "We conclude that mortgages totaling $75 million for the 14 projects we reviewed were excessive by $22 million, and in addition section 8 subsidies of $30 million will be paid for these 14 projects."

How many total projects were there under the combination of section 8 Moderate Rehabilitation coinsurance?

Mr. GREER. We have a pretty firm fix on the number that Benton did, and that is in the neighborhood of 50 to 55. We are not exactly positive of others, but there was a scattering of others with other lenders, probably in the neighborhood of between 5 and 10 other Mod Rehab projects that were in fact coinsured.

Senator GRAHAM. So you think your 15 then probably represented maybe 20 percent of the universe of similar projects?

Mr. GREER. The 14 that we audited, yes, sir.

Senator GRAHAM. Yes, the 14. So we could be talking about multiplying the numbers that you gave, if the other projects that were outside your survey were more or less similar to those that were in—I assume that your 14 were randomly selected to be representative of the total?

Mr. GREER. Not statistically random, but we were trying to get a cross section around the country and try to hit as many regions, as many HUD regions, as we can.

Senator GRAHAM. One of the things that I believe needs to be part of this systematic analysis is also a sense of outrage and urgency. Every month that goes by and that we continue to tolerate these excessive rents is that many more hundreds of thousands or millions of dollars lost to the American taxpayers and the loss of the opportunity to use those funds for some credible purpose, such as providing adequate housing for low income families, or contributing to a reduction in our Nation's fiscal deficit.

So I am going to be very insistent that we take an urgent rather than a leisurely pace in actions to suture these enormous wounds that we are suffering as a result of this 5- or 6-year period of indolence in the management of this program.

If you have any recommendations as to what could be done in order to energize the Department to go from rhetoric to action, I would be very interested in your thoughts.

Mr. ADAMS. We share your concerns, Mr. Graham, and as recently as yesterday I expressed those in some conversations with the housing staff. They assure us that they are moving as quickly as they can and second, and more importantly, that the delays in no way inhibit their ability to recapture those monies at a later date.

So in part, your concern is addressed. Their concern is, as expressed to me, that they proceed in the most orderly manner and the best informed manner, so they will not make bad decisions in the process. They want to get as much of the money back as they can.

I would share that with you, and I am sure that the housing spokesman will amplify on that for you.

Senator WIRTH. Mr. Chairman.

The CHAIRMAN. Yes, Senator Wirth.

Senator WIRTH. You noted that you had sampled these across the regions, and I understand the sample is relatively small. Are there any differences in regions that appear? Can you generalize in any way about that? Or, is the sample too small to make any generalizations?

Mr. GREER. The sample of 14 is probably too small for generalizations, but at Senator Riegle's request we did more work on the 45 projects that had been insured through November 1988. As we reported to them a couple of weeks ago, there tended to be a pattern in some of those areas of the economic problems caused by the oil crisis. I think it was 23 of the 45 projects were in States that had been impacted by the oil crisis. Your region, region eight, had quite a few.

Senator WIRTH. Now, why was that? Because there were regions that—why is that in the areas impacted by the oil crisis? Tell us about that?

Mr. GREER. That is where the Mod Rehab funds were allocated to those regions, and they went with the coinsurance Mod Rehab Program.

Senator GRAHAM. If I could also try and answer that, Senator Wirth, that goes back to how we have seen these programs being stitched together. Since the fair market rents were established first on a community-wide basis and second on data which tended to be 2 to 4 years out of date, there was a tremendous incentive to go into depressed areas within a larger metropolitan area and then into metropolitan areas which themselves were depressed. So that the real economics of the day were different than the economics upon which the community-wide rents had been set at a preceding date.

So by double-dipping under the fair market rent rules, you made these targets very attractive, vulnerable, and exploited. Then, we establish a capitalization requirement behind these, which is a nationwide standard, the one-third of 1 percent capital for companies that have disproportionate amounts of their activity in the areas of the country that are the most likely to result in failures, even under the best circumstances.

Is that a correct statement?

Mr. GREER. The provision, as I stated earlier though, is that the section 8 contract is sitting behind the deal, and the Government is paying the rent.

Senator GRAHAM. That just means that you are going to pay with the right hand or pay with the left hand; but one thing we know is that the Federal Government is going to pay.

The CHAIRMAN. I think we should note an affirmative nod from Mr. Greer, an inaudible response but nevertheless affirmative.

Mr. GREER. Senator Graham understands the system, yes, sir.

The CHAIRMAN. I just wanted to make sure that somebody reading the record understands that you in effect affirmed what he had just stated.

We are in the second part of the roll call. We are going to recess the committee. Senator Graham will chair the committee upon our return.

Senator GRAHAM. I think we can thank Mr. Adams and Mr. Greer for their excellent testimony today and their great service to this committee, to the Department, and to the Nation. Thank you very much.

Mr. ADAMS. I take it, I am excused to go to my other hearing?

The CHAIRMAN. Please do, and we will see you here again, I am sure.

Mr. ADAMS. Thank you, sir.

[Whereupon, the witnesses were excused.]

The CHAIRMAN. The committee stands at recess for about 10 minutes.

[Recess.]

Senator GRAHAM [presiding]. I will call the meeting to order. If panel No. 2 would please come forward.

STATEMENT OF PETER MONROE, CONSULTANT, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC, AND WALTER SEVIER, DEPUTY REGIONAL ADMINISTRATOR, TEXAS DEPARTMENT OF HUD, FORT WORTH, TX, ACCOMPANIED BY JAMES LOGUE, DEPUTY ASSISTANT SECRETARY FOR MULTIFAMILY HOUSING, HUD

Senator GRAHAM. For the information of Mr. Monroe and Mr. Sevier and others who will testify later, it has been our practice during the course of the hearings before the Banking Committee to swear the witnesses. We have previously done so with those who testified on panel one, as soon as we get the correct wording of the statement. We will proceed to do so now.

Our two panelists on panel two will be Mr. Peter Monroe, who is a consultant to the Department of Housing and Urban Development, and Mr. Walter Sevier, Deputy Regional Administrator of the Texas Department of Housing and Urban Development in Fort Worth,

Would you please stand and raise your right hand.

Mr. **MONROE**. We also have another person, Jim Logue, Deputy Assistant Secretary for Multifamily Housing at HUD.

Senator **GRAHAM**. Do you swear that the information you are about to give is the truth, the whole truth, and nothing but the truth?

[All say "Aye."]

Senator **GRAHAM**. Thank you.

Mr. Monroe.

Mr. **MONROE**. Mr. Chairman, I would like to briefly summarize my opening statement, but ask that the full text of my statement be accepted for the record in this hearing.

Senator **GRAHAM**. It will be so entered.

Mr. **MONROE**. Before I begin, let me thank you, sir, and the other distinguished members of this committee for inviting me to give testimony on behalf of the Department of Housing and Urban Development.

I would like to interject also that, on behalf of many of the new team, it is an exciting time to be here. We feel the opportunities are tremendous to be able to assist with the problems, any problems that are there. All of us are very pleased to be working with leaders such as Jack Kemp and Austin Fitts, who I feel have vision and commitment.

In my opening remarks, I would like to touch on the following subjects, and I also would like to emphasize that my primary role in my first few months as an advisor at HUD has been in the coinsurance program, per se. Therefore, I have brought along Deputy Assistant Secretary Jim Logue and others to assist to the extent that the questions really get into the mod rehab aspects of the program.

I would like to discuss with you why the coinsurance program was created, how it evolved, how it works, the problems associated with the program, and what has been done to date in response to these problems.

I overhead your concerns about getting on with it and moving, and I can assure you that there is no higher priority than really grappling with these very complex problems.

I will briefly also just state the relationship of coinsurance to Mod Rehab, and again rely on the experts for more detail. My purpose today is not to comment on major policy changes or proposed reforms. Secretary Kemp will very soon be proposing a series of policy changes and reform programs affecting the coinsurance program.

The final decisions have not yet been made, but I can assure you that Assistant Secretary Fitts and I will just be delighted to come back and in great detail go through the reforms, and why the reforms, and the specifics.

First, why was the program created. I think it is important to note that the program does provide financing for affordable multifamily housing. We recently looked at the average mortgage amounts in the program, and we determined that the average mortgage amount in the refinancing and purchase program was

$26,000. It was a little over $46,000 in the new construction and substantial rehabilitation program.

These mortgage amounts, when you apply debt coverage factors and you back out expenses, result in rents that people with incomes between $15,000 and $24,000 can afford, only paying 30 percent of their income for rent. On average, we are hitting a level of mortgage amounts and income that is below the approximate $54,000 average rental unit in the United States, and even further below the average FHA single family mortgage amount in the United States of $62,000.

The other thing I just wanted to point out is that although the Federal involvement in multifamily financing has fallen from 35 percent in 1982 to 8 percent last year, a lot of the difference was taken up by the other sectors, particularly the savings and loan and the bank industries. With the new risk-based capital reforms that are occurring which encourage single family versus multifamily, we expect that we will see more Federal activity, given these changes, over time.

I would like to summarize basically what coinsurance provides for borrowers. First of all, it provides many of the benefits that full insurance does: long terms, fixed rate financing, lower interest rates because of the use of the Federal credit power, fully assumable loans, nonrecourse debt, and pretty reasonable provisions with respect to allowing borrowers to prepay the loans.

There are also certain advantages to coinsurance that are available under full insurance. First of all, there is the borrower—and I have been a borrower in my life, but not in residential—looking for lenders who can be responsive and give them good answers. Coinsurance, by delegating most of the processing and underwriting decisions to participating lenders, enables borrowers to have one-stop shopping.

Second, the program has envolved to provide very important connections to the secondary mortgage market through Ginnie Mae and tax-exempt financing. Finally, sort of a piont related to the third, the program has allowed fast track processing and underwriting, just smoother and more rapid processes.

A brief history of coinsurance. Congress passed the coinsurance provision, section 244, in 1974, but it was not until 1983 that the administration came out at that time with a program that was workable.

There were two reasons for that, I gather. One is that there were attempts to work out a program with state housing finance agencies, and that was not really able to be developed during that period. Second of all, what was very important to making coinsurance work was the evolution of the relationship with Ginnie Mae to provide secondary financing.

The first program implemented in 1983 was the 223(f) program, which provided for the financing and purchase of existing projects; swiftly followed by section 221(d), which provided financing for new construction and substantial rehabilitation. Finally, in 1988, the nursing home program was implemented.

Overall program statistics just to keep in mind, 332,000 units, with the average mortgage amounts that I have stated earlier, have been financed, of which approximately 45,000 have been new or substantial rehab. So there have been significant achievements in the program that we feel we need to focus on, notwithstanding the many, many problems that all of us have experienced in this program.

Briefly, how the program works. It is really a complete delegation to the private sector of a series of functions. I think it is important to understand the processing of the loans, the underwriting of the loans, the management oversight, the disposition and, as I mentioned earlier, the secondary financing role.

Unfortunately, I quickly learned that the delegated underwriting system, as implemented, was more of an abdicated underwriting system. In return for the lenders assuming a share of the risk, the lenders received very substantial up-front fees, which we can discuss during the question and answer period. HUD also receives an insurance premium.

Briefly, coinsurance was used with the mod rehab Section 8 program. I believe in the questions and answers we can get into more detail as to how that works. Essentially, in May 1989, there were some significant changes that we feel make the program more viable, in combining mod rehab with coinsurance.

In terms of what went wrong, there were many things: loose entry standards for coinsuring lenders; inadequate HUD staffing; and domination of the industry by a few coinsurers whose practices of overmortgaging drove out more of the better lenders. When patterns of overmortgaging were discovered, HUD lacked the political will to take swift action. As the problems evolved, eventually lenders defaulted and we had the problems that we have today.

The many remaining problems that we have got, just to reiterate: lax coinsurance entry standards; loose underwriting requirements; insufficient developer cash in new projects; inadequate HUD staffing and skills. In terms of the quality of coinsurers, many are too small; the portfolios are too small for them to be viable. Capital and liquidity levels are too low to enable lenders to withstand serious defaults and to force lenders to take underwriting seriously. Even though we have already sanctioned in the last few months 10 coinsuring lenders, there are others who we feel need to receive sanctions.

To conclude, as disclosed yesterday in the FHA September 1988 audited financial statements, loss reserves in the amount of approximately $960 million have been established for this program. I will get into the default rates.

You know, you may be interested, Mr. Chairman, in going through some of the default rates in this program, as they relate to the default rate in the full insurance program. I think that is instructive. How well are we doing in coinsurance versus full insurance?

In general, what the default rates will show is that this is one very risky business, and we had better exercise great skill in this program. Secretary Kemp feels that the losses are completely unacceptable; 120 days ago we began a program to review the changes that could be made, and during that time we placed a moratorium on new entrants into the program and, as I said, took serious action with 10 coinsurers, so that we have now sanctioned 10 of the

39 coinsurers. There were really no sanctions prior to this administration.

The 120-day evaluation period is over. We have initiated a number of studies. The results are coming in. We have reviewed all 1,200 coinsurance projects out there, and we have made our recommendations to the Secretary. We expect that he will be making decisions shortly.

[The complete prepared statement of Peter Monroe follows:]

STATEMENT OF PETER MONROE
GENERAL DEPUTY ASSISTANT SECRETARY FOR HOUSING-
DEPUTY FEDERAL HOUSING COMMISSIONER-DESIGNATE
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SEPTEMBER 28, 1989

Mr. Chairman, and members of the Committee. I appreciate the opportunity to appear before you to discuss certain aspects of HUD's multifamily coinsurance programs. I will attempt to give you an overview of coinsurance: what coinsurance provides; how coinsurance works; what coinsurance offers borrowers; and how coinsurance has been used in conjunction with the GNMA Mortgage-Backed Securities and the Section 8 Moderate Rehabilitation programs. I will also share with you HUD's perspective on what went wrong with coinsurance and the steps this Administration has taken to date to assert control of the program and limit HUD's losses.

It is timely for you to have this hearing today, as Secretary Kemp nears completion of a reform package which will make policy and program reforms affecting coinsurance. We look forward to working with this Committee as you deal with the Secretary's forthcoming proposals.

What Coinsurance Provides

Pursuant to the National Housing Act, FHA has had a long-standing commitment to provide mortgage insurance to encourage the production and preservation of affordable multifamily housing for low- and moderate-income families. Notwithstanding the problems that have beset coinsurance (which I will discuss later in some detail), coinsurance has in recent years become FHA's principle vehicle for meeting this commitment.

Coinsurance offers affordable multifamily housing without direct subsidies to tenants or developers by making available long-term, fixed-rate financing within statutory maximum per-unit mortgage limits. Average coinsured mortgages range from $26,000 per-unit for existing projects to $46,600 per-unit for new construction and substantial rehabilitation projects. This translates into average monthly rents (assuming utilities included) of $360 for existing projects and $600 for new construction substantial rehabilitation projects. Assuming tenants are paying 30% of income for housing, coinsurance makes existing housing available to families with incomes over $14,400/year and new/substantially-rehabilitated housing to families with incomes over $24,000/year. Both of these figures are well below the national median household income of $27,700. Coinsured loans finance roughly 50,000 existing units and 15,000 new and rehabilitated units each year.

History of Coinsurance

Coinsurance was authorized under the Housing and Urban Development Act of 1974, which added Section 244 to the National Housing Act. However, it was not until 1983 that coinsurance was implemented for HUD's multifamily programs. In May 1983, HUD implemented the Section 223(f) coinsurance program for the purchase or refinancing and limited repair of existing projects. In August 1984, HUD made this program more flexible by increasing the amounts that could be spent on repairs; allowing those repair costs to be included in the mortgage; and permitting completion of non-critical repairs after endorsement. In October 1984, HUD implemented the Section 221(d) coinsurance program for new construction and substantial rehabilitation of apartments and retirement service centers. In October 1988, HUD implemented the Section 232 coinsurance program for new construction and substantial rehabilitation of nursing homes, intermediate care facilities and board and care homes. This program also allows loans for acquisition or refinancing of existing, fully insured facilities.

To date, more than 100 lenders have applied to participate in one or more of the multifamily coinsurance programs. 35 lenders are currently fully approved to participate in one or more programs. 29 other lenders have received preliminary approval. Coinsuring lenders are now located throughout the country. Some operate on a national basis; others have chosen to focus their coinsurance activities in a particular region.

Since 1983, close to 1500 projects with a total mortgage value of approximately $9.5 billion have been coinsured. The following table provides a breakout of coinsured loans closed and coinsurance currently in force. The difference between the two sets of figures is attributable primarily to prepayments and/or refinancings of approximately $1 billion of Section 223(f) coinsured loans.

TABLE 1: PROGRAM VOLUME AS OF AUGUST 31, 1989

	Loans Closed		Coinsurance in Force	
	Projects	Mortgage Amount	Projects	Mortgage Amt.
Sec. 223(f)	1,223	$7,144,199,100	1,020	$6,026,103,100
Sec. 221(d)	236	2,296,102,000	236	2,296,033,600
Sec. 232	5	29,126,300	5	29,126,300
Total	1,464	$9,469,427,400	1,261	$8,351,263,000

How Coinsurance Works

Coinsurance is a joint venture between the private and public sectors in which lenders and HUD share mortgage insurance risk, thereby providing an alternative to traditional HUD full insurance financing for rental housing and residential healthcare facilities.

In full insurance, all loan processing and underwriting is done by HUD field offices and all risk is taken by the Federal Government. Under coinsurance, HUD delegates to selected private-sector mortgage lenders the authority to originate, process and underwrite mortgage loans and issue firm commitments that bind HUD to coinsure those loans. HUD also delegates to coinsuring lenders full responsibility for loan servicing and management oversight, as well as acquisition and disposition of defaulted projects. Under coinsurance, the coinsuring lender assumes a portion of the risk for each loan it makes. In return for the lender taking a share of the risk and greater processing, underwriting and servicing responsibilities, HUD allows the lender to collect various application, financing and placement fees (which HUD collects under the full insurance programs) and to share with HUD the initial and annual Mortgage Insurance Premiums.

In full insurance, when a default occurs, the lender may assign the mortgage to HUD and receive insurance benefits. (Actually full insurance covers 99% of the lender's loss, since HUD charges a 1% assignment fee.) HUD is then responsible for foreclosing the defaulted mortgage, managing the project once it is acquired and, ultimately, disposing of it.

In coinsurance, when a default occurs, the lender does not have the option of assigning the defaulted mortgage to HUD. Instead, the lender must foreclose the mortgage and can file a claim only after it has sold the project or twelve months have elapsed after the date the project was acquired. After deducting the sales proceeds (or the higher of two appraised values if the project was not sold), the lender must absorb a deductible equal to 5% of the outstanding mortgage balance. The remaining loss is shared 85% by HUD and 15% by the coinsuring lender.

What Coinsurance Offers Borrowers

Coinsurance offers borrowers the same basic benefits available under HUD's full-insurance programs. These include:

- Long-term, fixed-rate financing
- High loan-to-value ratio
- Low interest rates resulting from the credit enhancement offered by FHA coinsurance and the availability of funding through GNMA Mortgage-Backed Securities (Note: Over 98% of all coinsured loans have been funded through GNMA MBS.)
- Fully-assumable loans
- Non-recourse debt
- Limited restrictions on prepayment

In addition to providing the same basic benefits of full insurance, coinsurance offers borrowers a number of significant advantages.

- First, essentially "one-stop shopping." Borrowers deal with lenders they know and choose. Borrowers do not deal directly with HUD. HUD's involvements are limited and are handled by the lender.

- Second, borrowers deal with lenders who have greater flexibility to respond to their unique needs and those of their projects. For example, most coinsuring lenders offer a variety of financing packages, including funding through the issuance of GNMA Mortgage-Backed Securities and tax-exempt bond financing.

- Third, borrowers get fast-track processing and underwriting, fast delivery of firm commitments and reliable scheduling for loan closings and project development.

How Coinsurance Works with GNMA's Mortgage-Backed Securities Program

As I stated earlier in my testimony, virtually all multifamily coinsured loans have been funded through the issuance of GNMA Mortgage-Backed Securities (MBS). Just as a lender must apply to FHA to become an approved coinsuring lender, it must secure GNMA's approval to become an issuer/servicer of GNMA MBS.

Unlike fully insured loans which are readily tradable as whole loans in secondary markets, coinsured loans have virtually no liquidity, since they can only be sold to other coinsuring lenders and each sale or assignment of a coinsured loan must be approved by HUD. Generally, the purchaser (assignee) must assume the full coinsurance risk of the originating lender. Coinsuring lenders have resolved this liquidity problem by using the GNMA MBS program to securitize their coinsured loans. Each multifamily loan comprises a single "pool", and securities are issued in multiples of not less than $25,000. Approved GNMA issuers may issue both Construction Loan Certificates (CLCs) to fund construction loans and Project Loan Certificates (PLCs) to fund permanent project loans. GNMA securities are very salable to secondary market investors since timely payments of principal and interest are guaranteed by GNMA, which has the full faith and credit backing of the U.S. government.

Appended to my statement is a chart that illustrates how FHA's multifamily coinsurance and GNMA's MBS programs work together. This chart is numbered to show the sequence of events involved in the creation of a coinsured loan and the issuance of GNMA securities. The following is a summary of those events:

1. & 2. The lender purchases a guarantee commitment from GNMA and GNMA issues that commitment.

3. A "warehouse" bank provides the lender a "bridge" or "warehouse" loan.

4. The lender uses funds from the warehouse loan to make the mortgage loan, which FHA coinsures.

5. & 6. The lender issues GNMA securities to a securities dealer (broker), who, in turn, markets the securities to an investor.

7. & 8. The investor purchases the securities from the broker, who, in turn pays the lender.

9. The lender uses the proceeds from the sale of the securities to pay off the warehouse loan, thus completing the transaction.

For the duration of the pool, the lender is obligated to make timely monthly payments to the securities holder (investor). If the mortgagor defaults and the project is acquired and sold, the lender is also obligated to pass the sales proceeds to the investor and to pay off the remaining pool balance following HUD's payment of coinsurance benefits.

If the lender fails to make any of the required payments to investors, GNMA will make those payments. In the event of such default by a lender, GNMA has the right to take control of all the lender's loans that are in GNMA pools. The coinsurance regulations entitle GNMA to full indemnification by FHA for any losses GNMA sustains in the process of servicing and liquidating these pools.

How Coinsurance was Used in Conjunction with the Section 8 Moderate Rehabilitation Program (MRP)

As I stated earlier in my testimony, coinsurance does not provide direct subsidies to tenants, project owners or developers. Owners or developers have been permitted, however, to use HUD full insurance or coinsurance in conjunction with the Department's Section 8 programs.

The following points illustrate how the Mod Rehab program, the principal Section 8 program using coinsurance, worked:

- **Under the Mod Rehab program, PHAs were required to establish rents for the units to be assisted based on the costs of amortizing the loan for the rehabilitation work added to the basic costs of owning, operating and managing the property.**

- When financing included coinsurance, the lender established mortgage insurance processing rents, which are required to be the lesser of market comparable rents or the Section 8 Mod Rehab Fair Market limitations.

- Some coinsuring lenders--and some HUD field offices--incorrectly interpreted the procedures covering HUD fully insured Mod Rehab projects as being applicable to the co-insurance program; accordingly, these lenders set the rents themselves, as agents of HUD. On the other hand, except in isolated cases where waivers were granted, the Department did not change its instructions that PHAs were to carry out the PHA responsibilities for setting Mod Rehab Section 8 contract rents.

- Audits of coinsured lender activities in the Mod Rehab program have alleged that Mod Rehab rents established during this period by such lenders were excessive for several reasons (i) rehabilitation work which would have been ineligible in the Mod Rehab program was included in the mortgage and rent calculations, and (ii) inflated comparables were used -- also contributing to higher mortgage amounts and excessive Section 8 rents. In 10 projects audited, the OIG estimated that millions in excess Section 8 subsidies would be paid out over the 15-year life of the HAP contracts.

- In January 1988, the Department issued explicit clarifying instructions; Mod Rehab Section 8 contract rents in coinsured cases were to be the lower of the PHA's cost-based rent calculations or the comparable rent established by the coinsuring lender. Subsequently, in May 1989, the insured processing procedures were made applicable to coinsured Moderate Rehabilitation projects but with the HUD field office, not the PHA nor the coinsurer, being responsible for setting the Section 8 contract rents.

What Went Wrong with Coinsurance

The coinsurance program did not attract experienced and well capitalized lenders for a number of reasons including: (a) loose entry standards and procedures; (b) inadequate HUD staffing, mortgage product quality and service; and (c) domination of the industry by a few coinsurers whose practices of overmortgaging drove out many of the better lenders. When patterns of overmortgaging by DRG and a few other lenders were discovered, HUD lacked the political will to ban them from the program -- thereby encouraging the overmortgaging practices. Eventually three coinsuring lenders defaulted on their GNMA pass-through obligations. GNMA was forced to assume their troubled portfolios and commence costly and time consuming foreclosure and disposition procedures.

Some of the key remaining program problems are summarized below:

1. HUD Program Deficiencies

-- Lax coinsurer entry standards.

-- Loose underwriting requirements.

-- Insufficient developer cash in new projects.

-- Inadequate HUD staffing (and lack of critical skills: e.g. CPA's and appraisers).

-- Absence of program goals (program financial performance) and information to monitor the achievement of program goals.

-- Limited, non-competitive mortgage products (e.g. 35 year paper requiring higher interest rates for GNMA investors); and lack of adequate customer service.

2. Insufficient Quality of Coinsurers

-- Portfolios are generally too small and generate insufficient servicing income (only 17 basis points) to be self-sustaining.

-- Lenders' capital and liquidity levels are too low to withstand even a small number of serious defaults.

-- In addition to 10 already sanctioned coinsuring lenders, there are others whose performance may warrant sanctions.

As a direct consequence of these program and lender deficiencies, the multifamily coinsurance program has experienced unacceptably high default rates. As these defaults evolve into claims, HUD will suffer significant losses in the General Insurance Fund. The following table provides the most current information on defaults and claims.

TABLE 2: COINSURANCE DEFAULTS AND CLAIMS AS OF AUGUST 31, 1989

	Defaults			Claims Paid	
	Projects	Mortgage Amt.	%*	Projects	Amount Paid
Sec. 223(f)	140	$ 800,863,000	13.2	23	$66,895,766
Sec. 221(d)	11	117,612,800	5.1	0	0
Sec. 232	0	0	0.0	0	0
	151	$ 917,475,800	11.0	23	$66,895,766

*Percentage of coinsurance in force.

As disclosed yesterday in the FHA September 1988 audited financial statements, loss reserves in the amount of approximately $960 million have already been established for the coinsurance program. The difference between the $67 million above and the $960 million loss reserve reflects the time lag between a loan going bad and the ultimate claim being paid. This time lag underscores the importance of proper accrual accounting, advocated by Secretary Kemp and GAO to permit early recognition of program problems.

It is informative to compare the coinsurance default rates with those in full insurance. Coinsurance default rates are currently 13.2% for 223(f) (5% excluding DRG's portfolio and defaults) and 5% for 221(d). (Given the newness of the 221(d) coinsured mortgages, the current 5% figure significantly understates the ultimate default rate for that program.) Default rates for fully insured 223(f) and 221(d) projects are respectively 6.9% and 17%. The full insurance loss severity rate for 221(d)(4) during the last two years is approximately 40% and the loss severity rate for coinsured 223(f) projects is 55% (50% excluding DRG). Clearly, these factors show that even in full insurance financing is a risky business requiring great skill.

Corrective Actions Taken to Date

Secretary Kemp has taken a series of actions to assert control over the coinsurance program and to limit HUD's losses.

First of all we have initiated a comprehensive review of the Department's multifamily coinsurance programs. This review has included the following features:

1. Moratorium on New Coinsuring Lender Applications/Approvals

During HUD's review and evaluation of the program, we are not accepting any new applications for approval of coinsuring lenders. There are also restrictions on HUD processing of lender applications received prior to the beginning of HUD's evaluation last May.

2. Expansion of HUD Monitoring

HUD is increasing its remote and on-site monitoring of all existing coinsuring lenders. During the evaluation period, HUD Headquarters and Field Offices are reviewing lenders' processing and underwriting for all coinsured loans. By creating new computer-based systems, HUD is also increasing its capacity to remotely monitor the financial performance of individual coinsured projects.

3. Evaluation of Coinsuring Lenders

HUD is evaluating all active coinsuring lenders with respect to: (a) quality of past and current underwriting; (b) levels of defaults and claims; (c) capitalization and liquidity in relation to portfolio size; (d) credit worthiness; and (e) compliance with other program requirements. The purpose of this evaluation is to identify lenders who should be put under closer scrutiny and/or administrative sanctions (i.e., probation, suspension or withdrawal of approval).

4. Review and Revision of Program Requirements

HUD has engaged the accounting firm of Price Waterhouse to review the coinsurance programs' capital and financial reporting requirements. At a meeting with coinsuring lenders on June 6, 1989, Housing announced that it intends to significantly strengthen requirements in these areas. To the extent that lenders have real and substantial capital "at risk", they should be motivated to underwrite sound loans.

HUD is also reviewing other program features, including the lender approval process; project appraisal and underwriting of coinsured loans; loan management; monitoring and program enforcement. Since the beginning of HUD's evaluation we have issued ten coinsuring lender letters to implement various program changes.

HUD also has increased its enforcement activities with respect to coinsuring lenders who have violated program requirements as follows:

1. Suspension

DRG Funding Corporation has been suspended from participation in all Federal Government programs. Fuller

Mortgage Associates, Southwest Funding Group and Concord Mortgage Company have been suspended as coinsuring lenders.

2. Probation

Six lenders (Benton Mortgage Company, Citadel Mortgage Company, Carnegie Evans, L.P., Washington Capital Associates, Integrated Funding, Inc. and Cincinnati Mortgage Company) have been placed on probation for six months. While on probation, these lenders may not issue firm commitments without HUD Headquarters' prior review and approval.

3. Close Monitoring

Three lenders have been notified that their coinsurance underwriting is being scrutinized by HUD because of irregularities detected through remote monitoring. During the 120-day evaluation period, Housing will continue to use its remote monitoring capabilities to identify lenders whose underwriting warrants closer scrutiny.

On July 6, 1989, Secretary Kemp announced that, until further notice, HUD is suspending full insurance and coinsurance for Retirement Service Centers. HUD will honor firm commitments outstanding as of that date, but will permit no new commitments until the program has been thoroughly evaluated and redesigned to serve the needs of low and moderate-income elderly.

Conclusion

Our current review of the multifamily coinsurance programs, as well as earlier audits by HUD's Office of Inspector General, clearly indicates that further policy and structural changes are needed to make coinsurance viable. HUD welcomes any opportunity for dialogue with this Committee as we work to achieve the goal of affordable housing for American families.

Senator **GRAHAM**. Thank you very much.

Mr. **MONROE**. Thank you, sir.

Senator **GRAHAM**. Mr. Sevier.

Mr. **SEVIER**. I do not have an opening statement. I am here to answer any questions or be of whatever assistance I can.

Senator **GRAHAM**. Thank you.

Mr. Monroe, you indicated that within the last 120 days there has been an intensive review of these programs. Could you indicate what has been the agenda of this review? What have you been focusing your primary attention on?

Mr. **MONROE**. Yes, sir. First of all, HUD has been really an expert in reviewing real estate and the value of real estate, and understanding real estate. HUD has never really been in the business of being a bank examiner. It has never really been in the business of looking at financial statements and determining whether these are really financially sound entities that we are dealing with, and whether or not they can sustain their coinsurance obligations.

REVIEW BY OUTSIDE ACCOUNTING FIRM

So one of the first things that we did was to hire an outside accounting firm to come in and help us, and to take a look at the capital requirements and see if they were correct relative to the risk-based capital standards that are being used in business and also the State insurance laws.

We also had them review whether or not we were getting financial statements that made any sense. So that was one of the areas that we felt that we should dig into first, an area that we just were not that good at.

We also wanted to know with some assurance as to what the condition was of all of these 1,200 projects out there. Were many of them at risk? Were many of them having high vacancy rates, and the only reason that they had not shown themselves up in defaults was because there had been large escrows? What was really going on out there? That was one of the things that we did.

We spent a lot of time, many meetings with all sorts of industry experts and groups, to help us understand how we could improve the program and make it work the way it was supposed to, without killing the program.

I think you very correctly said, come on, it has been a number of months, give us some recommendations. This is the most complex program I have ever looked at. Anybody can tighten the program down; but if you tighten the program down too far, then you really will eliminate the program. Because of the fact that it provides affordable housing and is the primary Federal involvement in multifamily housing, we did not feel that the right thing to do was to kill the program, but was to try to find the line where we could cause good underwriting in the future while at the same time protecting the $7 billion of portfolio that is out there.

So those are some of the things that we have done. We also eliminated the retirement service center program, when we studied the default rates in there, a lot of which was in coinsurance. We terminated that program because the default rate was just excessive and completely unacceptable.

Senator **Graham**. I share your concern for not wanting to overreact and cause the demise of some constructive programs that are serving important public needs. But I would also suggest that the thing that is killing this program now is the kind of information that we heard this morning from the inspector general, and that this committee has heard repeatedly going back into the spring of this year, and that our colleagues in the House have also been developing.

That underscores my sense of urgency that, if we are going to recapture public confidence in this program, we need to do something and do it prudently but with a sense of expedition.

For instance, it seems clear that the level of capital requirements for participation by insurers in this program is grossly inadequate, and rendered more so by what has been a pattern of targeting these projects into the softest areas of the Nation's economy.

Why does it take a long period of study to determine that capital requirements are inadequate, and to begin to move to strengthen them?

Mr. **Monroe**. We have begun to move. We do not want to repeat the mistakes of the past. As I said, HUD has never really had expertise in bank examining and understanding financial statements. We have been real estate experts, and not financial experts. That is why we went out and had a firm like Price Waterhouse advise us on what kind of capital standards make sense. They did a very thorough analysis, and we are just now getting their final report and their recommendations.

SOME OF THE ISSUES

It is easy to say increased capital. I mean, that is logical, and I understand exactly what you are saying, and that certainly is implicit in the testimony. How do you define net worth? What sort of elements do you allow? What sorts of loan loss reserves do you want to require?

These are very complicated and difficult issues, and we are trying to do it properly. These are the same issues that the savings and loan industry and other people have been struggling with, and they have been struggling with them just as hard. So we are trying to do it right. We are very close to having it. Believe me, we spent a lot of Saturday and Sunday nights trying to come up with a good system.

Senator **Graham**. Well, I would just say, there has been considerable experience in the private sector with private mortgage insurance programs that ought to give you an advanced stage from which to start your analysis. Some of that advanced stage is going to be positive, and unfortunately a lot of it is going to be negative as well.

But we are not approaching this from a Christopher Columbus standpoint. We have crossed this ocean before.

Mr. **Monroe**. Let me say this. There are no private mortgage insurers to speak of that are in the multifamily business, so it is kind of a Christopher Columbus situation. I met with the private mortgage insurers, and asked them why they have not. Underwriting in the context of multifamily is very different from underwriting in the context of single family. Actuarially, you cannot make generalizations with respect to multifamily because, as you know, the valuation process in commercial properties is much more income-value oriented than the simple comparable approach that you use in single families. So to do it right and to do it actuarially is very difficult.

To determine the right capital requirements relative to what you project in terms of losses becomes very difficult. So then, you ask yourself, what is the best way? How can you come up with a level of capital that is appropriate? We thought the most appropriate way to do it was to look at what the banks were doing, and to look at the State insurance agencies in other areas, what they were imposing, to try to come up with some sort of a comparable approach. But we just did not have good data to base it on.

Senator GRAHAM. What is your timetable for carrying out this agenda of reform?

TIMETABLE FOR REFORM

Mr. MONROE. It is definitely my understanding that an announcement will be forthcoming very soon. Then there are, as you know, clearances through the Department, clearances through OMB, and then the very important public and Congressional clearances that have to take place.

A whole team is in place, and we are poised to work on it as fast as we can get it done. We share your sense of urgency, honestly.

Senator GRAHAM. I am concerned. I read early this morning a letter that was written from a central office agency to a representative of a private developer, which seemed to fairly casually, by letter, modify what the inspector general thought the laws and regulations had been relative to the establishment of fair market rents.

If we could move with such ease to make the programs vulnerable, why can't we move with a similar sense of expedition to protect the public?

Mr. MONROE. I honestly believe—I cannot imagine that we could be working in a more expeditious manner to reform coinsurance. The FMR program is a Mod Rehab issue, but we are working, believe me, with complete diligence to develop a program that balances on the one hand allowing the continuation of Federal involvement in multifamily financing and, at the same time, being tough enough to make sure that that financing produces mortgages that are underwritten properly and that can be backed by the coinsurers' financial statements.

We honestly have worked very hard at it. It is a very high priority.

Senator GRAHAM. Going back to the question of timetable, do you think that by the first of November, December, January, that some of these urgent corrections may be in place?

Mr. MONROE. Some of them, absolutely. May I say that—I have only been here a few months—the things that we can do, there are some things that we can do administratively. Of course, you really should recognize that the actions taken with respect to 10 of the 39 coinsuring lenders, to either suspend them or put them on probation, is something that we could do quickly, and we did.

The fact that we stopped new lenders coming into the program was something that we could do administratively, and we did. So wherever we can act on any of these reforms administratively, we will do them overnight, just in the same manner that you pointed out that the letter went in the other direction on FMR's. We will do it right away.

If we can accomplish any of these changes by an interim rule rather than a proposed rule, we will jump on that. If it requires a proposed rule, we will expedite every departmental clearance and do what we can to move on that.

Some of the changes may be statutory, and those may require a separate timetable. I would be delighted to report to you, to let you know exactly how we are doing as we go, because we really feel that we are after this and on it.

Senator **Graham**. We have been joined by Senator Cranston. Senator, do you have an opening statement or questions?

OPENING STATEMENT OF SENATOR ALAN CRANSTON

Senator **Cranston**. I'd first like to thank Senator Graham for his leadership and diligence in chairing this important set of hearings.

It is important that we fully understand the nature of the abuses and mismanagement of HUD under the Reagan administration. Specifically, the use of coinsurance in Mod Rehab projects was a key form of waste and abuse.

Yesterday, GAO testified before the Subcommittee on Housing that the FHA fund lost over $4 billion last year alone—much of that resulted from mismanagement and outright fraud in the Coinsurance programs. The Reagan administration underestimated the damage by almost $3 billion. This enormous disparity in financial reporting raises a serious question of whether there was a deliberate coverup of a major disaster.

One primary source of defaults is the coinsurance programs. We need to understand the weaknesses of those programs when used alone. And we need to understand weaknesses of the programs when used in conjunction with other HUD subsidized programs such as section 8 certificates.

Senator Graham mentioned a troubling, but well taken, point about existing Coinsured/Mod Rehab projects. Although defaults in this area are few, the Federal Government is paying indirectly in the form of inflated rents. This practice must stop.

I want to thank all of today's witnesses for helping us understand and solve this problem. I am confident that this Congress will pass major legislation that will bring sweeping reform to HUD and will mobilize the country's ability to meet our pressing housing needs.

The Senate Housing Subcommittee, which I chair, is conducting a major series of hearings on the financial strength of FHA. Some umpleasant revelations were made before our committee yesterday about the huge and unexpected losses, although there obviously is not a comparison to the amount of loss in the FSLIC situation and we run no risk comparable to what happened there in terms of actual cost comparison.

We are determined to ensure that FHA is rebuilt as a strong institution. Management of coinsurance is a key source of the problems we face. We are preparing for a major hearing on coinsurance, and how that program can be less subject to fraud and abuse.

As I understand it—and correct me if I am wrong in this understanding—relatively few coinsured Mod Rehab projects are now in default. This is due, I understand, largely to the rents that were often set at a rate that the IG now considers excessive. Is this a fair explanation as to why few of these projects have defaulted?

Mr. MONROE. Absolutely.

Senator CRANSTON. Is there a way to correct it so that HUD is not overpaying rent for what might be vacant units?

Mr. MONROE. Could you repeat that, sir? I am sorry.

Senator CRANSTON. Is there a way to correct the rents, so that HUD is not overpaying owners for rents which may be vacant, units which may be vacant?

Mr. MONROE. Are you talking about the rent setting for Mod Rehab levels?

Senator CRANSTON. Yes.

Mr. MONROE. I will tell you what I know about it, but I would like to defer to Mr. Logue on Mod Rehab matters, as I explained to Senator Graham. We have changed the rules with respect to how we do Mod Rehab calculation of contract rents.

Simply stated, HUD, as of May 1989, now is the one who is setting those rents, rather than anybody else. Therefore, those kinds of considerations should be taken, I would think.

Could you follow up on that?

Mr. LOGUE. I assume the question relates to payments that may be——

Senator CRANSTON. We are talking about past projects, of course.

Mr. LOGUE. Right now, the number of coinsured Mod Rehab projects that were completed amounts to about 60, since 1986. In fact, as the inspector general pointed out in his report, there are serious questions about the rent setting process in those Mod Rehab coinsured projects.

In fact, we are instituting a very significant review of those projects, to analyze the way the rents were set. If we find that the rents were set inappropriately, we have various remedies, including reducing the rents retroactively to the point in time that they were calculated incorrectly. That in fact is what we will do, if it is appropriate, considering the insurance on the project.

With regard to vacant units, there is a limited ability for owners to receive payments for vacant units, dealing with turnover or lack of occupancy initially. But that is a very limited stream or period of time that those payments can be made to vacant units. We expect that, in situations where section 8 assisted units are available, they should be rented on a very expeditious basis. If in fact we find that the rental of those units is not proceeding in a timely fashion, then those payments can be discontinued.

But there are normal vacancy factors that affect even assisted units. When people leave there is usually a period of time when you must paint or refurbish the unit and do the processing to assure that income eligible tenants are available to occupy the unit, but that is a very limited period of time.

Senator CRANSTON. If we do reduce rents that appear to be excessive, can that be done without risking default since the reduced rents may mean that the owner cannot pay the mortgages.

Mr. LOGUE. That is a very serious question, Senator, and it is something that we have taken up as an issue in this process. In fact, 2 weeks ago, we had a meeting, including the inspector general, to discuss that very issue.

Obviously, if we are in a position where reduction in rents may be appropriate in a Mod Rehab coinsured project, and those rent reductions would result in a default on the mortgage, we have not really gained anything, if our payment on the FHA side is more than the funds that we would recapture through the rent reduction.

So we are now analyzing exactly what process we will use to make that determination in situations where a project has excessive rents and is coinsured, and to try to make that fine determination as to whether a reduction in the rents will precipitate a default.

As I mentioned, the inspector general has offered their assistance in reviewing some of the cases that we have inhouse right now, to try to make some of those determinations and see what level of flexibility we would have in those particular circumstances.

Senator CRANSTON. I fully intend to seek reform of coinsurance included in the major legislation that we expect to move either late this year or early next year. So I want you to be aware that time is running out on getting advice to us, recommendations to us, the recommendations that you think we should take into account when we do that.

Obviously, mortgage lenders have every reason to want their borrowers to receive as much assistance as possible, insofar as such assistance increases the prospects for eventual repayment. So developers have the incentive to layer one Federal subsidy program on top of another, without any review by the responsible mortgage lenders.

REVIEW MECHANISMS OF FEDERAL SUBSIDIES

What kind of review mechanisms has HUD employed to ensure that the total amount of Federal subsidies provided, particularly to developers for specific projects, is appropriate?

Mr. LOGUE. Let me try to address that, as far as what we have instituted within recent history. We have recognized that the combination of various Federal and even in some instances State and local subsidies to projects can have that layering effect. Often, there is a question as to who—are the forms of assistance accounted for in HUD's determination of what the appropriate level of assistance should be?

With regard to Mod Rehab, particularly, and some of the problems we have found with regard to coinsured Mod Rehab projects, we have as of May, and even before that we had in practice a requirement that the field offices review the rent setting process in any coinsured Mod Rehab project, so that it is a HUD determination as to the level of assistance that should be provided through Mod Rehab rents, and so that it is not a coinsurer's determination or even a public housing authority's determination, which we found in the past was either not done, or done incorrectly.

So we have placed the burden of assuring that the rent levels are appropriate on the field offices. We believe that that is an appropriate place to have those determinations made.

With regard to other forms of assistance—and I think one of the forms that has been identified has been the application of the use of low income housing tax credits in projects that received other forms of assistance—we have instituted a review of all of our programs, not just Mod Rehab but any program that we would provide assistance to, that might involve the use of low income tax credits.

We are in the process of assuring that all forms of assistance, including low income tax credits, are taken into account when HUD provides its level of assistance to a particular project.

In the instance of Mod Rehab, we would institute—and since we do not have any right now, it is not a particular issue; but we have for the new round and any new rounds of assistance that we would be putting out—we will be essentially requiring that in the rent setting process the Department will take into consideration the other forms of Federal assistance, including tax credit, in its determination of rents.

Senator **CRANSTON**. What kind of procedures has HUD employed to ensure thorough and consistent regulation when two or more subsidy programs are combined in a single project?

Mr. **LOGUE**. I am not sure what happened previous to the administration's coming on-board, Secretary Kemp. But from the perspective of what we have done since we have been on-board and what we will do prospectively, we will be developing processes to make the determination to assure that, when there are various forms of assistance on one particular project, there is a methodology for assuring that those assistances, those various forms of assistance, do not have a compounding effect that would lead the Federal Government to pay more than is reasonable or necessary to make the project work.

In the case, for instance, of projects where we are doing property disposition work-outs, where we are negotiating and having foreclosed properties at the Department that the Department owns, and working out arrangements with nonprofit sponsors for example to take over HUD-held inventory, we have analyzed the assistance level that HUD would apply through the loan management set-aside units; taking into account the other forms of assistance that will be coming into the project, and in particular tax credits.

We will be implementing that kind of analysis and review on all forms of assistance that the Department provides.

Senator **CRANSTON**. I just have one more question, and I would appreciate a brief response because we have a roll call to go to.

Under the coinsurance program, HUD has essentially delegated oversight authority to participating lenders. Under the Mod Rehab Program, HUD has essentially delegated oversight authority to its field offices. When the two programs combine, it seems like something would have to give, and it sounds like in some cases everything just gave.

What policies is HUD following to ensure that the projects do not fall through the regulatory cracks?

Mr. **Logue**. As I think in particular of Mod Rehab, the most significant area of abuse that we have found was the process of setting rents, and who in fact was setting the rent. In many cases, it was the coinsured lender. As I mentioned earlier, what we have instituted now, and have clear instructions to the field on, the field office will set those rents in Mod Rehab projects, not the coinsuring lender and not the PHA.

Mr. **Monroe**. Speaking from the insurance side, the coinsured lender is required to use those rents that are determined by HUD, so there is now that control. One of the things that we have recognized is what Senator Graham was referring to earlier. Given the different lengths of mortgage insurance and subsidies, we have to make sure that when we are underwriting the projects they are still going to work when the subsidy is gone, so that we do not have the kind of problems that we now have, that if we roll the rents back in Mod Rehab we are going to have an unfeasible project.

Senator **Cranston**. Thank you very much.

Senator **Graham**. Thank you, Senator.

EVALUATION OF CURRENT PROJECTS

I would like to follow up on a question that Senator Cranston was asking relative to the evaluation of the current projects, where there has been a determination of excessive rents, and your attempt to determine whether it is economically more or less advantageous to reduce the rents, run the risk of default, or keep paying the excessive rents and have some greater assurance that there will not be a default.

In making those judgments, how are you factoring in other downstream benefits, particularly the low income housing tax credits?

Mr. **Logue**. That will be one of the elements that we will take into consideration. The basic problem, however, I think that we will face with the tax credits will be the likelihood that a lot of the benefits or the cash that was raised through the sale of the tax credits may have already been distributed at the point in time early on in the process.

Senator **Graham**. As I understand the program—and this is not exact, and you may correct me if I am too far off the mark—generally, the low income tax credits will be available for 10 to 12 percent of the cost of construction, for a 10-year period after approval. Is that a correct statement?

Mr. **Logue**. As far as the level, I think the cost of construction—that is a reasonable level.

Senator **Graham**. Typically, what the developer does is, through securitization or a partnership or some technique, the project ends up selling off that stream of tax credits for generally 40 to 50 percent of their value, their gross value, which represents their discounted current value, to an investor group. Is that correct?

Mr. **Logue**. That is a likely scenario for how that would work, yes.

Senator **GRAHAM**. When the investor group purchased those, they understood that that risk was that that stream of tax credits would in fact continue to be available, which I assume is in part contingent on the project continuing to be viable and in private hands. That is, if the project defaults, I would assume that the Federal Government would no longer pay tax credits for a project that was essentially now owned by the Federal Government because they had taken it in an FHA default.

Mr. **LOGUE**. That would be probably a likely scenario. In fact, they may be subject to some retroactive recapture of any benefits that they have received. That is correct.

Senator **GRAHAM**. I think that is an important point. One of the things that we have learned in this committee is that it has been a great seminar for education on perverted economics. In the S&L area, we had set out so many protections that had caused people to be unconcerned relative to the real economics of the transactions that they were about to enter.

I think we may have found another case of where people have been inattentive to the fundamentals of the economic transaction, feeling that they were protected by the Federal Government from the necessity to be so concerned. That is the end of my editorialization.

I apoligize, but we are down to the second bell on this vote. We have been informed that there may be another vote immediately after this one, so this recess could be in the nature of 30 minutes, if in fact we end up having two back-to-back votes. I will return as promptly as possible, and we will continue. Thank you.

[Recess.]

AFTERNOON SESSION

Senator **GRAHAM** [presiding]. The meeting will come to order.

We have just been voting on the appropriations bill for your Department. At one of our earlier hearings, I asked the question of a representative of the Department as to whether the funds provided for the supervisory activities of the agency were sufficient to avoid some of the problems that have developed because of inadequate supervision.

The answer to that question was affirmative. I would like to ask of you if you would monitor what is going to be happening, and ask the appropriate people in the agency to do so. If in the course of consideration of the appropriations, their concerns arise as to the level of resources available for oversight and proper monitoring at the central office and regional office levels of these programs, I would appreciate it if you would make that fact known so that we can attempt to weigh in on your behalf.

I think it is critical that Congress not contribute to a continuation of this series of problems through failure to provide adequate resources.

I would like to ask Mr. Sevier some questions from his perspective. Mr. Sevier, can you tell me, say over the last 5 years, what have been your responsibilities?

Mr. **SEVIER**. Over the last 5 years, I have been the Deputy Regional Administrator in Fort Worth, which includes the 5-State area in region 6, Southwest. We have obviously had our problems with the economy with what has happened to oil, and relative to the coinsurance, Senator, is that——

Senator **Graham**. Yes, I was going to ask from that vantage point in the field, and particularly in an area of the country that has been the source of a number of specific projects that have caused problems. I would be interested in your perspective on how the coinsurance program and the Moderate Rehabilitation Program have worked, and your comments on what should be the administrative and congressional agenda for reform.

MOD REHAB/COINSURANCE PROGRAMS

Mr. **Sevier**. Our experience I guess has been somewhat typical with the coinsurance program. We have in our region probably $600 million of coinsurance in force.

Senator **Graham**. Is that for Moderate Rehabilitation?

Mr. **Sevier**. No, sir. We would have about $55 million for the 11 projects that are combined coinsurance and Mod Rehab. Our experience with those projects, you know the combined projects, the 11, has been typical. At this point, the projects are doing all right as a result of the rents. We have the same problems and concerns that the rest of the Department has.

Currently, the IG is taking a look at these projects, determining the appropriateness of the rents.

Senator **Graham**. Excuse me for interrupting, but I assume you also had some section 8 Moderate Rehabilitation projects which were not coinsured. Is that correct?

Mr. **Sevier**. We have some in our region that were not coinsured, and these projects are at the present time, most of these projects are doing okay.

Senator **Graham**. Do you have any comment as to whether the rent levels on the noncoinsurance section 8 Mod Rehab were significantly different, assuming common circumstances, than those projects which were coinsured?

Mr. **Sevier**. Not a great deal of difference, really. I think some of the coinsured projects have higher rents in certain instances than the others. But as a group, there would not be a great deal of difference at this time.

Senator **Graham**. Have you had any difference in default level between those that were coinsured and those that were not coinsured?

Mr. **Sevier**. Not at the present time, no, sir.

Senator **Graham**. And would you attribute the same reason to the nondefault rate among the noninsured or noncoinsured, and that is the fact that the rents were at a high enough level that they were able to support them?

Mr. **Sevier**. The rents were at a high enough level to support them, but basically in our region we have a lot of housing problems and a surplus of housing in certain areas. Basically, with the guaranteed income stream from the section 8 contract, these projects for the most part are successful.

Now, we have some section 8 projects that are not, but they are not mod rehab.

Senator **Graham**. Well, while you have been observing the coinsurance program and the section 8 Mod Rehab, what have you considered to be the most vulnerable areas, the most significant areas subject to abuse?

Mr. **Sevier**. If I could, let me talk about the coinsurance program totally, which would include the Mod Rehab, of course. To summarize the problem, in our region coinsuring lenders on occasion have what appears to be—they have inflated the income stream, lowered the expenses, and basically have come in with an unrealistically high value and obviously an unrealistic mortgage amount.

It is difficult for these projects to debt service, and they are likely to go into foreclosure. In fact, out of our $600 million portfolio at the present time, we have about 35 percent, 36 percent, in default. Most of this, again, goes back to unrealistic mortgage amounts.

Senator **Graham**. Under the program as it was explained earlier by Mr. Adams, the coinsurer and in some instances the public housing authority involved were to come to the field office of HUD with a proposal as to the amount of the mortgage and the fair market rental. Is that the procedure that operated in Fort Worth?

If so, why did these excessive rents and mortgage levels not get picked up?

Mr. **Sevier**. That is the way the process worked, but when you combine coinsurance with Mod Rehab the rents would come into the HUD field office basically for review and approval. But the problem in that area, under the coinsurance program, the cost of the project, that is the initial cost of the project plus the rehabilitation work, would justify the higher rent. So the field office basically was placed in a position of almost rubber stamping or approving the rents, because again the cost of the projects would support the rent.

Now, the achilles heel in the process, in my opinion, is the fact that under the coinsurance program we were not allowed to review or analyze the underwriting of the coinsured lender. We had to accept their underwriting as basically a fact of life. So when they came in and said that their costs justified the rent, we had no basis to disagree because we could not review their underwriting.

Senator **Graham**. We had a letter that was written in 1987 relative to a project in which the Washington office of HUD had said that there was not to be a comparison of market comparability in the field offices' evaluation of fair market rents.

In Fort Worth did you make any effort to evaluate what was actually being paid in the marketplace for rents, as a check on the fair market rents which were being presented by the coinsurer?

Mr. **Sevier**. We made some checks to try to come up with comparisons, but it basically was for our information and discussions with the coinsuring lender in Washington. But again, we were in the box of having to accept their determination.

Let me give you an actual example. There was a process in Texas, Mod Rehab, where basically the mortgage amount on it, if I recall, was about $8 million. In our opinion, with the income approach to value, the rents, et cetera, if we were underwriting that it would probably result in a mortgage of around $6.5 million. So we had that difference. But the final result was that the project was underwritten at the higher rate.

Senator **Graham**. Now, where did the directive come that said that you could not interject yourself in that process?

Mr. **Sevier**. Under our coinsurance handbook, 223(f) handbook, field offices do not get involved in the underwriting. We make suggestions, we review, we try to catch this. We pointed it out to the central office saying that these projects are coming in, their value and the mortgage amounts are too high. They cannot be supported by the income. They are going to go into default.

Senator **Graham**. So are you saying that the underwriting evaluation was done at a level above the field office, or was not done at all?

Mr. **Sevier**. No, Senator. I am saying that the underwriting was performed by the coinsuring lender.

Senator **Graham**. I said the evaluation of the underwriting judgment of the coinsurer. Are you saying that it was done at a level above the Fort Worth office, or that it was not done at all?

Mr. **Sevier**. To answer your question thoroughly, the handbook in the coinsurance program states that the evaluation will be an after-the-fact monitoring, and that will be done by central office, not by the field.

Senator **Graham**. So you say——

Mr. **Sevier**. It really was not done, in many cases.

Senator **Graham**. You are really saying that neither at the field office nor the central office was there a second opinion given on the coinsurer's statement of what was an appropriate level of mortgage?

Mr. **Sevier**. In most cases, that is correct. There was no opinion given. I mean, the field office—and again, I do not want to push this too hard, but in fairness to our field offices, speaking for region 6, in almost all cases when we had a difference of opinion or we felt the underwriting was not correct, we pointed that out. We pointed it out to central office, and they apparently took it into account when they would do their monitoring.

I do know that the two audits that were performed by the IG, I think in 1985 and 1988, we had a lot of discussion with them. I think quite frankly that we helped them get started in that audit.

Senator **Graham**. For the record, you referred to a project for which the coinsurer had recommended an $8 million mortgage, and you thought that a $6.5 million mortgage was supportable. What was the name of that project?

Mr. **Sevier**. Pebble Creek Project in Arlington, TX.

Senator **Graham**. Pebble Creek Project in Arlington, TX.

Mr. **Sevier**. Right.

Senator **Graham**. When you sent up to the central office your concerns and information that you had developed, and suggested that they take it into account in monitoring, what was your evaluation of how well that information was utilized?

Mr. **Sevier**. It did not appear to be utilized very much, if any.

Senator **Graham**. Who was the person to whom you were reporting this information?

Mr. **Sevier**. Typically, my concerns would be addressed to the Assistant Secretary for Housing.

Senator **Graham**. And who was that?

Mr. **Sevier**. That would have been Mr. Tom Demery, and before that we had two or three people that were in the job a short time acting, Dave Barthomas and then going back I guess as early as Maurice Barksdale through the present.

But I would like to offer a comment, if I could; that under Secretary Kemp there is a 180 degree change. The field is involved in the coinsurance program, our suggestions are taken into account, and I know that there are situations where the Department has not insured projects as a result of the concerns expressed by the field.

Senator **Graham**. So the policy of not rendering a second opinion, either at the field or the central office level, but restricting the Department involvement to a monitoring after the fact, that set of practices you say is no longer in effect?

Mr. **Sevier**. Basically, we have not yet announced, or central office has not, our changed procedures in coinsurance. So one answer to your question would be that our process and procedures are being looked at, are in the process of being changed, have not been changed yet. But it is a difference in attitude and concern, and the way it operates on a daily basis now we do have a much greater role.

Senator **Graham**. If the Pebble Creek project had come to you, let's say, on the first of July 1989 and you had had the exactly same economic concerns as you expressed when it in fact did come before you, how would it have been treated?

Mr. **Sevier**. I am confident that central office would have stopped it as a result of the field's concern.

Senator **Graham**. I thought you said that there had not been any change in practices, and the old practice was that the central office did not render a second opinion until after the project was in being, or an after-the-fact monitoring basis.

Mr. **Sevier**. I am sorry if I have confused you. My comment was that our regulations or handbook instructions have not been changed yet. But even though our procedures have not changed as of yet, Washington will intervene in a project, will review it, and will take appropriate action now, which did not happen before; even though, again, our handbooks and procedures have not been rewritten yet.

We are operating differently in that, again, if a project now comes to the attention of Washington and it looks as if the underwriting is not satisfactory, then the Department will intervene and basically make certain the underwriting is correct, or stop the process and take whatever appropriate action.

Senator **Graham**. Senator Pressler has joined us, and I am going to ask him if he has any questions, but again, the temptation to editorialize has overwhelmed me. The good news in what you have just said is that a practice that clearly was subject to abuse has been restrained. The bad news is that there seems to be a great deal of looseness and ambiguity as to the procedures within the Department if something as important as this is in the handbook, as opposed to being in public regulations.

And then, if even the handbook is not being adhered to, and that is an accepted way of doing business with the Department today, those loose practices are serving legitimate public purpose, shutting down an abuse. But yesterday, those same loose practices were being used to create exactly the same target of opportunity for greed.

I would hope that the Department, as a result of this, would try to institutionalize some greater internal discipline and clarity in its standards and procedures, and particularly to move items into the public review of regulations, rather than the black box of sort of informal understandings.

TWO PROBLEMS IN THE COINSURANCE PROGRAM

Mr. **Sevier**. If I can make one final comment on that, I think that in my opinion from the field's view there were two problems with the coinsurance program generally. One concerned the fact that perhaps there were some fallacies in the program, such as inadequate capitalization and these issues. These are the things that it is my understanding that the Department is in the process of changing.

The second problem—and again, this is the field's view—is that the procedures and processes that were in place were not in my opinion adequately enforced. I think what we are seeing now is the adequate enforcement, adequate application of existing policies, and the changing of policies that will make the program even better. Again, using the capitalization requirements is one example.

Senator **Graham**. Yes, Mr. Monroe, and then Senator Pressler for further questions.

Mr. **Monroe**. We totally share your concern about what is going to be happening until the new regulations are in place. Very much.

I would like to mention maybe four things that we are doing, just to really make it clear that we believe we have a handle on things while this is going on. One is in the case of every project, even if the coinsurer is in good standing, we look at and review that commitment before it is endorsed.

So if the coinsurer has issued a commitment prior to endorsement, we can only stop them if there is fraud or misrepresentation. Otherwise, we have to endorse. But we look at it, we look at what the field has said. In 10 cases, as opposed to none prior to I believe 1988—but in 10 cases in 1989 we have actually either suspended or put on probation the coinsuring lender, because of what the field has spotted in this review process.

Then, in the case of someone who is on probation, in that case if a project comes in for precommitment review and the project is bad, we have the right to say no, and we do. If the field basically says it is not right, then we normally back up the field.

The other item is just the retirement service centers. There was such a problem that we simply eliminated that program. So we feel that we have cut down our exposure while this process is going on.

I should have mentioned also that we stopped any new entrants into the program. No new applications, and no people allowed to receive full delegation until we have the new regulations in place.

So we are very concerned during this interim period, just as you are. We feel you are absolutely right.

Senator **Graham**. Incidentally, is Benton Mortgage still participating in the program?

Mr. **Monroe**. Yes, sir, but they are under probation, which means that they cannot actually issue a firm commiment until we have reviewed it. This process is called precommitment review. So we do have that control that we did not have before they were on probation.

Senator **Graham**. Senator Pressler.

Senator **Pressler**. Thank you very much. I have to leave to make a quorum in the Foreign Relations Committee a little bit later, but I do have a couple of quick questions. In Foreign Relations, we are trying to decide whether to send some money down to Nicaragua to influence an election, so it is a little different issue than we are facing here.

In any event, I might address this to Mr. Monroe. With the reduction of Federal funding for multifamily housing over the last decade, do you believe it is important that HUD stay in the multifamily insurance business?

FEDERAL MULTIFAMILY INSURANCE PROGRAM

Mr. **Monroe**. Well, we feel that the Federal multifamily insurance program is important, as I mentioned in my statement, because it provides housing. It provides housing subject to mortgages that are affordable by people with incomes below the median. And we do feel that there is a very substantial need for affordable multifamily housing. We feel that this program at present is the best alternative that we have to address that need.

Senator **Pressler**. With all the problems that have occurred with the coinsurance program, is it too risky to stay involved?

Mr. **Monroe**. It is risky. There is no question about that. We think that we can take a number of steps to substantially reduce the risk, and also to make sure that that risk is fully shared by the coinsuring lenders, up to their maximum 20 percent, which currently in many cases, and especially in the case of DRG, has not been because the capital just was not there.

So we feel that—and this is obviously subject to the Secretary's decision, Secretary Kemp's decision—but we have set forth a whole range of options for him to consider in making up the final decision as to whether to go forward with the program.

Senator **Pressler**. This is sort of a general fundamental question. Listening to these problems, it seems to me that maybe we have a basic structural problem. Yesterday, we heard Ms. Fitts talk about a 4-year strategic plan. The new administration, under your leadership and Mr. Kemp's leadership, is taking a whole group of initiatives about overall management structure, and so forth.

Are the people there to do the work? That is, speaking of the fact that government salaries are so low, that in many of these decisions that we are talking about that require somebody with the training of a CPA at least to make a judgment and some experience—however good the leadership is or however good the plans are, 2, 3, 4, or 5 years down the road we may well have a situation that we have had all of these great overall intentions but—is there a basic structural problem?

This thing in the housing administration has struck me that it is true that there were problems at the top, it is true that there were problems in decisionmaking, and I do not excuse those. But is it a basic structural problem that the business deals are so big that the people that we are asking to do them are not making the right judgments? Some of these people are $50,000 a year people who have to make these huge decisions. Is the structure there for reform?

Mr. **Monroe**. I think that is asking exactly the right question. The role of HUD, especially in coinsurance, is really very, very different than the traditional processing, issuing insurance roles in the past. As I mentioned earlier, we never in the past required the skills of CPA's to determine whether or not the financial statements of coinsurers were gimmicked-up or not.

Senator **Pressler**. That the financial statements were what?

Mr. **Monroe**. It is now our role, rather than just looking at the value and the quality of a piece of real estate, we now have to get in there and determine whether or not the financial statements of these coinsurers are sufficient to: one, withstand project defaults; and two, that there is enough capital in there that the coinsurers are serious about making an underwriting decision because they have real risks.

Those are roles that HUD has never had to perform before. We have not had people with those skills before. So that is one example.

The other example is, since we are delegating underwriting, the type of people that you need in order to exercise oversight, actually processsing the applications themselves, these are different skills.

As you say, it is a structural change. What we are doing is, we are going through, person-by-person, every single person in HUD, to find out what their skill levels are, and then to determine where those skills ought to be supplemented either by additional hirings with new types of skills or contracting out, going out and finding accounting firms that can provide CPA audit services or appraisal services. So I think that question is right on point.

Senator **Pressler**. So increasingly you have to contract out to get these sorts of high-level skills? In that structure, there is probably a long-range problem. You can contract out for consultants and for—I used to be with McKinsey and Company years ago. They would make a great plan, but somehow there has to be the structure there so that the civil servants who are there permanently can evaluate these things.

I wonder if we are giving enough attention to that. But apparently, you are.

Mr. **Monroe**. We are looking at every single person, and looking at every option that we can to bring in skills with outside contracts.

Senator **Pressler**. Good. Thank you, Mr. Chairman.

I may have some more questions for the record.

Senator **Graham**. Thank you.

I would like to first follow up on the line of questions that Senator Pressler was asking, and then return to where we were before.

As I understand it, coinsurance came into the law approximately in 1974, but it was not until 1983 that the coinsurance program as it applies to multifamily housing was activated by the Department. Is that a correct statement?

Mr. MONROE. Yes, sir.

Senator GRAHAM. Two questions. At the time that the Department decided to put this program that had been sort of on the shelf into action, did the Department feel that it had sufficient capabilities to supervise and monitor? If it did not, if it had the same conclusion of its inadequacies in 1983, do you have any sense of why it would have implemented a previously dormant program?

Mr. MONROE. I was not there. The basic concept of the system, as you suggest, or as I suppose, was deemed valid, and is still deemed to make sense. Now, why it was that there was not a recognition of the kind of skill changes that would be necessary to properly administer this program, I cannot answer. It is a mystery. It is a mystery to me.

We have only recently begun getting Dun and Bradstreet credit reports on these coinsurers. Why that was not done before is a mystery to me.

Senator GRAHAM. I will follow up on another question of Senator Pressler. Prior to 1983, these multifamily projects were being financed through the conventional FHA insurance programs. Was there then, or is there now, an analysis of what economic benefits either the tenant or the Federal Government as the subsidizer of rents receives through the availability of FHA insurance on these mortgages, as opposed to having them financed in the private marketplace?

Mr. MONROE. I have not seen it, but that does not mean it necessarily does not exist. Clearly, the use of the Federal insurance power, by eliminating that risk of loss, lowers interest rates and enables housing to be built at lower rents, and therefore more affordable housing. So, you know a priori that one can conclude.

Also, the availability of Ginnie Mae secondary market financing is a mechanism that is a clean mechanism, that provides availability of funds for multifamily housing, I have not seen anything that quantifies it.

I think it is a very excellent question. Is that responsive?

Senator GRAHAM. That really goes to the question of, what is the basic incentive of FHA insurance on these mortgages, which is a predicate question to the issues that then get involved in coinsurance. Is that insurance a necessary element of making these projects economically viable?

Mr. MONROE. I should also mention this, I should have thought of this. The FHA certainly historically has performed an innovative role of taking some risks on new types of mortgage instruments that ultimately get accepted into the marketplace. Certainly the long-term fixed-rate mortgage financing vehicle is something that the FHA really pioneered and that has become more of an industry standard.

Now we need to get ahead of it, and to continue to be innovative.

DEFAULT OF COLONIAL HOUSE PROJECT

Senator **Graham**. Mr. Sevier, I would like information on a specific project. I understand that you have had some experience with the Colonial House project. Where is that located?

Mr. **Sevier**. That project is located in Houston, TX.

Senator **Graham**. It is my understanding that the DRG mortgage firm appraisal projected an inflated rent roll and occupancy level, and that the project has since defaulted and has been resold at a fraction of its original mortgage. Since this was a federally coinsured mortgage, the taxpayer I assume now is picking up the difference.

Could you explain to me how the process broke down, as it relates to Colonial House?

Mr. **Sevier**. Yes, sir. I became aware of Colonial House in August 1984.

Senator **Graham**. Was Colonial House—did it also have any section 8 financing?

Mr. **Sevier**. No, sir.

Senator **Graham**. It was a straight market rental?

Mr. **Sevier**. Section 223(f) coinsurance, without subsidy. Straight market rental.

The HUD field office manager in Houston called me and said—again in August 1984—that he had been contacted by DRG and they were going to be coming in within a few days for HUD to insure the mortgage on Colonial House at a value of $60 million, a $47,200,000 mortgage. I shared the manager's concern.

I went to Houston, took two of my staff with me, appraisers. We looked at the project at the time, and were concerned about the value. In fact, in our opinion the project was probably worth at the time somewhere in the neighborhood of $13 million, as compared to the $60 million value placed on it by DRG.

Senator **Graham**. You thought the project was worth how much?

Mr. **Sevier**. $13 million.

Senator **Graham**. And DRG said it was worth?

Mr. **Sevier**. $60 million.

As a result of our concerns, I had several telephone conversations with the Assistant Secretary, Commissioner of FHA mortgages, Barksdale. Mr. Barksdale shared my concerns. He was from Texas, was familiar with the area, and we had several conversations.

But the final result of all of this concern was the fact that Mr. Barksdale called me and said that he had this reviewed by the Office of the General Counsel in HUD and by the Secretary's office, and that we had no choice under the statutes and the regulation but to insure the project, and that we were directed to insure it.

The final response—I did not want to push it too far, I was not an attorney; but the legal staff in the regional office as well as the program people felt that we could decline to insure this based on misrepresentation of the value and misrepresentation is one of the reasons that HUD can refuse to insure a project.

But again, the final decision was made as I described. We did insure the project, as you stated. It was sold this past May for I think $8.9 million.

Senator **Graham**. And what was the value of the FHA mortgage that was insured?

Mr. **Sevier**. $47,200,000.

Senator **Graham**. What if any part of that mortgage default did DRG pick up?

Mr. **Sevier**. Under the circumstances, I do not know that they picked up any of it. Probably not.

Senator **Graham**. So you assume that the full amount of the mortgage became an obligation of the Federal Government?

Mr. **Sevier**. I do not know for certain, but that is my assumption, yes, sir.

Senator **Graham**. What possible law or regulation could mandate that the Federal Government insure a project which it thought was worth $13 million for a stated value of $60 million?

Mr. **Sevier**. In my opinion, it definitely should not have been done. We wrote memoranda to Washington. We talked with them on the phone. We did everything we could, but it had no effect. It never should have happened.

Senator **Graham**. Are you aware of any particular personalities that were involved in either the ownership of Colonial House or in its representatives that would have caused such a bizarre position to be taken by the central office?

Mr. **Sevier**. No, sir. Not really.

Senator **Graham**. Thank you. Thank you very much, thank you, Mr. Sevier.

Mr. **Monroe**. Yes, sir.

[Whereupon, the witnesses were excused.]

Senator **Graham**. Ms. Beasley, would you please stand and raise your right hand. Do you swear that the testimony that you are about to give is the truth, the whole truth, and nothing but the truth, so help you God?

Ms. **Beasley**. I do.

Senator **Graham**. Thank you.

Thank you very much for representing the position of the Mortgage Bankers Association.

Ms. **Beasley**. Mr. Chairman, I have a short oral statement, and then longer testimony which we will be introducing into the record.

Senator **Graham**. It will be filed in full in the record.

STATEMENT OF GAYE G. BEASLEY, PRESIDENT, PATRICIAN MORTGAGE CO., REPRESENTING THE MORTGAGE BANKERS ASSOCIATION OF AMERICA

Ms. **Beasley**. I am Gaye Beasley, president of the Patrician Mortgage Co. of Washington, DC, and Jacksonville, FL. I am testifying today on behalf of the Mortgage Bankers Association of America.

MBA appreciates the opportunity to appear before you today and testify on the Federal Housing Administration's coinsurance programs. We understand the Committee's concern about the section 8 Moderate Rehab Program and its interrelationship with the coinsurance program. However, as other parties are here to address the interaction of the two programs and because most of our members have not coinsured section 8 Moderate Rehab projects, we will limit our remarks to the coinsurance program.

As detailed in our testimony, the FHA insurance and coinsurance programs have filled a much needed role in the production and maintenance of affordable housing. Despite the recent difficulties involving these programs and the Department of Housing and Urban Development, MBA urges you not to let these problems obscure the fact that there is a need for FHA insurance and coinsurance. The programs should be administered properly, fairly, and in the most efficient manner possible.

These programs have been successful. Since 1937, when the FHA multifamily insurance programs were first implemented, over 3.8 million units of multifamily housing, including 313,000 coinsurance units, have been provided. Over $75 billion of mortgages, including approximately $9.5 billion in coinsured loans, have been insured or coinsured.

The coinsurance program has become invaluable, as it has been a key source of reliable, long-term, fixed-rate financing for multifamily housing. It fills a gap which cannot and will not be met by other entities.

At present the thrift institutions face the new risk-based capital rules that limit investment in assets such as multifamily housing. The life insurance companies face investment requirements which favor lending to top quality projects for large developers. The new Federal National Mortgage Association delegated underwriting product line is limited to existing properties.

Thus, the FHA section 221(D)(4) program is the only significant source of fixed-rate construction and permanent financing for proposed rental projects. The section 223(F) program, which allows refinancing for a variety of purposes, is an invaluable source of liquidity and potential funds for new projects. The FHA insurance and coinsurance programs are readily combined with Ginnie Mae mortgage backed securities, which are issued to investors to provide funds for rental housing projects.

One misperception that needs to be cleared up is the issue of the up-front fees to the coinsurer. Although HUD regulations allow the coinsurer to charge up to a 3.5 percent financing fee plus a three-tenths of 1 percent application fee and, for new construction loans a five-tenths of 1 percent inspection fee, the marketplace and the feasibility of the projects dictate much lower fees.

Moreover, the costs of the multiple reviews required by HUD and paid for by the coinsurer, as well as the funds set aside in a mandatory loss reserve, require the lender to expend a substantial portion of the up-front fee collected.

MBA commends the committee for continuing the effort to determine why the problems have occurred. HUD has recently suspended or restricted several coinsurance lenders involved in the coinsurance of existing properties and new construction properties. These actions were taken because of unsound underwriting practices, and/or the failure to meet net worth requirements. Although it is not yet clear whether fraud was actually involved or how widespread the unsound underwriting practices may have been, it is quite clear that the program will suffer losses.

The problems with coinsurance portfolios underwritten on existing properties appear to be caused by overmortgaged projects and by loans on apartments in deteriorating markets. The losses on new properties have been at least partially caused by an inability to judge the new demands of the elderly market.

Although the HUD inspector general has provided figures on coinsurance defaults, MBA understands that the program's default rates are being reexamined by HUD. We also ask the committee to note that a large percentage of the defaults appear to have been generated by a very small number of lenders.

MBA recognized early that problems were arising in the newly implemented coinsurance program. In July 1986, MBA sent a letter to HUD Secretary Sam Pierce outlining MBA concerns about the alarming number of defaults.

MBA also made several recommendations for increased monitoring and, if necessary, sanctions. These are detailed in our testimony. In May of this year, MBA also recommended that HUD take several other actions on coinsurance:

To increase monitoring and enforcement of underwriting standards; devote additional staff and resources to the coinsurance programs, revise claims procedures; increase capitalization; allow joint coinsurance of large project loans; encourage reinsurance of project loans; and develop options for assisting troubled projects.

MBA looks forward to working with the committee to solve identifiable problems and to continue to assist in the provision of multifamily rental housing. We urge the committee to consider that, without FHA insurance and coinsurance, the ultimate impact on capital resources used to finance affordable moderate and middle income multifamily rental housing could well be devastating.

The FHA insurance and coinsurance programs, if properly administered, can provide tremendous social benefits to the Nation.

[The complete prepared statement of Gaye G. Beasley follows:]

1125 Fifteenth Street, N.W.
Washington, D.C. 20005
202-861-6500

Mortgage Bankers Association of America

STATEMENT OF

GAYE G. BEASLEY
PRESIDENT
PATRICIAN MORTGAGE COMPANY

on behalf of

THE MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

Oversight Hearing on the
Department of Housing and Urban Development
Section 8 Moderate Rehabilitation and Coinsurance Programs

September 28, 1989

Mr. Chairman and Members of the Committee. I am Gaye G. Beasley, President of the Patrician Mortgage Company, an FHA-approved mortgagee and approved coinsurer. I am testifying today on behalf of the Mortgage Bankers Association of America.* I am a past member of MBA's Board of Governors, past Chairman of MBA's Insured Project Committee, and currently Chairman of MBA's Affordable Housing Task Force. MBA's Insured Project Committee is comprised of virtually all mortgagees who participate in HUD's multifamily housing programs. Accompanying me today are Burton C. Wood, MBA's Senior Staff Vice President/Legislative Counsel, and Ann vom Eigen, MBA's Associate Legislative Counsel.

MBA appreciates the opportunity to appear before you today and testify on the Federal Housing Administration's (FHA) multifamily coinsurance programs. Most of our members have not used the Section 8 moderate rehabilitation program, and consequently have not used it with the coinsurance program. As other parties are here to address the interaction of the two programs, we will limit our remarks to the coinsurance programs. These programs fill a much needed role in the production and maintenance of affordable multifamily rental housing. Despite the recent difficulties involving these programs and the Department of Housing and Urban Development (HUD), MBA urges you not to let these problems obscure the fact that there is a need for the programs. The programs should be administered properly, fairly, and in the most efficient manner possible.

---

*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

Insurance and Coinsurance Success

The FHA multifamily housing programs provide needed opportunities to deliver and preserve affordable multifamily rental housing for all income levels. The FHA muitifamily insurance programs have successfully increased the availability of rental housing. According to HUD, since 1937 over 3.8 million units of multifamily housing have been provided through the FHA insurance and coinsurance programs, and over $75 billion of mortgages have been insured, including almost $9 billion of coinsured loans.

Under the full insurance programs, lenders worked with developers to arrange project financing, and FHA staff performed the critical functions of appraising and inspecting eligible projects. Unfortunately, during the last decade HUD became one of the victims of Federal budget and staffing reductions. Budget authority for HUD fell from over $38 billion in 1978 to a proposed $14 billion for FY 1990. The funding reduction and the drive to reduce the number of Federal employees also affected FHA. MBA has seen a gradual erosion in FHA's ability to staff the multifamily full insurance programs and meet the demands of a competitive and volatile marketplace. HUD now faces substantial difficulties processing fully- insured applications on a timely basis.

With the implementation of the coinsurance programs in 1983, HUD delegated to certain FHA-approved private lenders the project underwriting responsibilities that it no longer had the staff to perform. Under the coinsurance programs, FHA-approved coinsuring lenders originate, process, underwrite, close, and service loans. In exchange for the ability to perform these functions, approved mortgagees assume responsibility for a portion of any insurance loss on the coinsured mortgage. In the event of a claim, the coinsuring lenders absorb as a loss the first 5 percent of the outstanding loan balance. The rest of the loss is shared 85 percent by HUD and 15 percent by the coinsuring lender.

HUD believed that, because coinsurers put 20% of their own capital at risk, with monitoring, the coinsurance program would produce housing at little cost to the government. Since the coinsurance program was initiated, it has provided more than $9 billion of secondary market capital for 313,000 thousand units of rental housing. The efficiency of the program and its role as a reliable source of funding enabled lenders to raise capital for housing at attractive fixed interest rates and for long mortgage terms. The FHA commitment to insure and to coinsure is easily combined with the Government National Mortgage Association (GNMA) guarantee, and most coinsured lenders are also authorized to issue GNMA mortgage- backed securities (MBSs). Wide acceptance by investors of the AAA rated GNMA MBSs provides a tremendous source of secondary market capital for multifamily housing. This capital has been efficiently and effectively tapped through the coinsurance programs.

Filling the Market Gap

FHA full insurance and coinsurance programs were designed to provide a constant and reliable source of long-term fixed rate financing not otherwise available in the private sector for multifamily housing. Capital sources for multifamily housing over the past 30 years have ebbed and flowed. The unmet market need which drove the initial creation of the HUD multifamily programs still exists today and, as described below, has been exacerbated by recent events in the marketplace.

Moreover, because lending for multifamily projects competes with other investment opportunities, many of the past sources of capital have been cyclical, driven by an institution's or investor's need to maximize yield. Therefore, the FHA coinsurance and full insurance programs will continue to be needed as a reliable and constant source of capital for rental housing.

Thrift institutions essentially have provided floating rate financing, tied to prime, or some fixed- rate financing at five and/or ten year terms. However, with the adoption of the new risk-based capital rules, the majority of the thrift institutions have already limited or discontinued their multifamily lending in an effort to meet capital guidelines. Many life insurance companies and other institutional lenders became active multifamily lenders in the 1980s, but because of their investment requirements, these entities generally lend on top quality properties for the largest developers. The Federal National Mortgage Association (FNMA) has recently created a delegated underwriting and servicing product line of programs, similar in concept to HUD's coinsurance program, but limited to loans for existing properties. While the Federal Home Loan

Mortgage Corporation finances some multifamily housing, its program is limited. In light of these market developments, FHA programs will take on increasing importance.

Although these programs are described in the testimony of other witnesses at this hearing, MBA can attest to their practical viability. The FHA Section 221(d)(4) coinsurance program, designed to provide mortgage insurance to finance the construction or substantial rehabilitation of rental or cooperative multifamily housing for moderate income households, currently provides a unique source of fixed-rate construction and permanent financing for proposed rental projects. Few institutions are willing to lend at fixed interest rates through the construction period and for a long term permanent loan thereafter. However, with the credit enhancement and standardized underwriting, construction standards, inspection and loan servicing provided by the FHA insurance programs, institutions and individuals are willing to invest in GNMA MBSs that are both highly liquid and secure investments.

The Section 223(f) program was initially established in 1974 as a refinancing vehicle for existing projects that served a number of purposes. The program allows individual owners of properties overly burdened with high interest rate first or second mortgages, to recast mortgages over a longer period of time and/or at lower interest rates. An owner might also refinance to reduce carrying costs, thereby maintaining affordable rents or to afford repair or property upgrades and to preserve the units as rental housing. Current HUD regulations limit the amount of funds that can be taken out of a project for refinancing. Without a source of refinancing, many owners of older, middle-income housing would be forced or induced to sell their asset or convert apartment units to condominiums in order to realize a market rate return on their investment.

Current Problems

MBA commends the Committee for seeking to determine why the problems at HUD and in the coinsurance program developed. The December 9, 1988, "Report on Audit of the Section 223(f) Coinsurance Program" by the HUD Office of Inspector General (OIG) indicates that 12.8 percent or $671.5 million in original mortgage value of the coinsured loans outstanding as of May 1988 was in default. However, the same report indicates that of the $671.5 million in default, nearly $538 million was defaulted mortgages originated by DRG Funding Corporation. Excluding DRG's portfolio, the OIG's report indicates that as of May 31, the program default rate would be about 5 percent. HUD recently has suspended or restricted several coinsured lenders involved in the coinsurance of new construction properties because of unsound underwriting practices and/or failure to meet net worth requirements.

The problems with many coinsurance portfolios appear to be caused by over-mortgaged properties and by loans on apartments in deteriorating markets. The industry also believes that most of the losses for new construction properties will result from loans on retirement service centers for the elderly. The real estate community, including developers, lenders, and HUD, all seriously misjudged the scope and demands of the elderly market, and the intensive initial capital requirements to market and operate new retirement properties for the healthy elderly.

MBA recognized early that problems were arising in the new coinsurance program and, on July 8, 1986, former MBA President Ronald Poe sent a letter to HUD Secretary Samuel Pierce outlining MBA's concerns about the alarming number of early defaults

(Exhibit #1). In that letter, Mr Poe wrote that these problems (unsound project underwriting and insufficient management oversight) threatened to undermine the coinsurance programs unless prompt and immediate action was taken by the Department to monitor lender performance and to impose appropriate sanctions where necessary. Finally, Mr. Poe noted that MBA strongly believes that the Department must allocate additional staff and resources to ensure that lender performance is adequately monitored.

In a response, dated August 4, 1986 (Exhibit #2), Secretary Pierce stated that he recognized that monitoring is a critical element of the coinsurance program, and indicated that he would move forward in that effort. Since that time, MBA has continued to stress to HUD the importance of the monitoring process on numerous occasions in meetings with HUD officials.

Proposed Solutions

The questions the Congress and the Administration must address are two-fold. First, attempts must be made to quantify the mortgage insurance premium income from the programs, as well as to obtain a realistic projection of potential losses on presently outstanding coinsured loans, and likely projected losses on newly originated loans once more careful monitoring procedures and underwriting guidelines have been implemented. Second, after determining these revenues and the net projected losses, Congress must weigh the dollar cost, as well as the social cost, of closing down or severely restricting the program at a time when FHA field offices are incapable of processing any measurable volume of multifamily housing through the full insurance programs.

Recommendations

In May 1989, MBA also developed recommendations for program reforms, which were provided to HUD, and have also been provided to this Committee's staff. (Exhibit #3) In brief, MBA recommends:

1. Increased monitoring and more rigorous enforcement of program requirements: As in the past, MBA encourages the Department to develop an effective system for monitoring coinsuring lenders so that potential problems and abuses can be detected early and corrective actions taken. We recommend on-site monitoring by the Department on a rotation basis. We also recommend the development of a rigorous enforcement policy to ensure compliance with program standards. Monitoring will only be effective if the Department takes quick action to enforce policy to ensure compliance with program standards. MBA is willing to assist the Department in the development of policies and procedures pertaining to monitoring enforcement.

2. Increased staffing: MBA recommends that HUD adequately staff the Coinsurance Division and FHA field offices to ensure that new initiatives and effective monitoring are fully and properly implemented. MBA also believes that FHA needs additional staff to provide timely processing for those full insurance projects that are still processed by HUD.

3. Revised claim procedures: HUD could also reconsider its claims procedures, and possibly shorten the time in which lenders bear most of the costs on

defaulted properties. The current claims procedures can severely drain a coinsurer's resources. At present, regulations force the coinsurer to carry most or all of the financial burden for a year or more before HUD will pay a claim.

4. Increased Capitalization: MBA believes that HUD must increase capitalization and net worth requirements for participating lenders in coinsurance programs. A copy of MBA's letter of June 20, 1989, to Mr. Peter Monroe, HUD General Deputy Assistant Secretary Designee, which discusses this issue, is also attached. (Exhibit #4)

5. Joint coinsurance of project loans: MBA recommends that the Department give consideration to a policy that would allow coinsuring lenders jointly to coinsure large project loans. This would provide a mechanism for shared risk and a system of checks and balances in underwriting and managing loans. Furthermore, this would mirror the standard practice in the banking industry to participate out loans that are in excess of a bank's legal lending limits.

6. Reinsurance of project loans: Since it is in the best interest of the Department and the industry as a whole to maximize the financial capacity of coinsuring lenders, we recommend that the Department encourage the use of reinsurance by facilitating approval of reinsurance documents and by reducing the coinsuring lender's share of the risk when reinsurance is used. The use of reinsurance would provide an additional system of checks and balances in underwriting project loans because reinsurance agents would

review the underwriting of each loan before agreeing to reinsure it. Furthermore, reinsurance would provide an additional source of funds to cover project losses should they occur.

7. Programs for assisting troubled projects: In cases where loans do become troubled, coinsurers should have available all of the resources available to lenders under the full-insurance programs. We recommend that coinsuring lenders be permitted to coinsure Section 241 Supplemental Loans and Section 223 Operating Loss loans. These changes would enable coinsurers to provide developers who are experiencing short term cash flow problems with a means to fund deficits and to recoup their capital contributions through second mortgages on the projects once they begin to generate income.

In conclusion, Mr. Chairman, FHA's multifamily programs are critical to the financing of affordable rental housing projects. MBA believes that it is essential that both vehicles of processing (coinsurance and full insurance) are available to meet the diverse needs of the market. With regard to coinsurance, Mr. Chairman, MBA has offered a variety of recommendations that I have outlined today to improve this program. If the coinsurance programs and their approved lender participants are monitored by HUD, coinsurance will continue to supply a critical and reliable source of long term, fixed rate apartment loans for properties primarily serving low- and moderate-income tenants. Without this program, the ability to deliver FHA insurance will be in jeopardy. We urge the Committee to consider that without FHA insurance and coinsurance, the ultimate impact on capital resources used to finance affordable moderate- and middle-income rental housing would be devastating. The FHA insurance and coinsurance programs, if properly administered, can provide tremendous social benefits to the nation.

MBA looks forward to working with the Committee to solve identifiable problems in the coinsurance programs, and to continue to provide multifamily rental housing.

EXHIBIT #1

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Ronald F. Poe, CMB
President
(202) 861-6500

July 8, 1986

The Honorable Samuel R. Pierce, Jr.
Secretary
Department of Housing and Urban Development
451 Seventh Street, S.W.
Washington, D.C. 20410

Dear Secretary Pierce:

I am writing on behalf of the Mortgage Bankers Association (MBA) to express our grave concern with the continued operations of the Multifamily Coinsurance program. Since 1983, when the Department of Housing and Urban Development (HUD) unveiled the 223(f) Coinsurance program for existing apartments, a number of problems have surfaced involving unsound project underwriting and insufficient management oversight which have been documented in a HUD Inspector General's Report dated November, 1985. These problems now threaten to undermine the Coinsurance program unless prompt and immediate action is taken by the Department to monitor lender performance and to impose appropriate sanctions where necessary.

As you know, one of the primary objectives of the Coinsurance program was to facilitate the processing of multifamily mortgages by allowing private lenders to perform the underwriting, loan servicing, and management functions in return for sharing part of the insurance risks with HUD. The delegation of these underwriting responsibilities to lenders was intended to reduce the exposure of the FHA Insurance Fund, and provide staff savings to HUD. However, to provide adequate safeguards under the program and ensure that lenders engage in prudent underwriting practices, the coinsurance regulations mandated that HUD staff carefully monitor lender performance. As such, HUD Handbook 4566.1, Coinsurance for Mortgage Lenders, Section 223(f), incorporates a number of control mechanisms which include conducting on-site reviews, post-endorsement monitoring and periodic audits by the Commissioner.

To date, however, the Department has been quite reticent in monitoring lenders and taking appropriate sanctions where lender abuses have been found. Because of our concern about the quality of loans originated under the 223(f) program, MBA has been monitoring the default activity of 223(f) mortgages. Our review of the data indicates that approximately eight (8) projects totalling $122 million are in default -- or five (5) percent of the total $2.425 billion HUD has underwritten in 223(f) coinsured mortgages. These figures are quite alarming in light of the brief two-year history of the 223(f) Coinsurance program.

MBA is deeply concerned that these projects could go into foreclosure resulting in a tremendous financial loss to the Department and posing a threat to the future of the Coinsurance program. Such a development would have a devastating effect on the mortgage banking industry, particularly for those lenders who have fully complied with HUD guidelines and invested a substantial portion of their company's capital and resources into the Coinsurance program.

Although MBA understands the financial constraints that have been imposed on the Department as a result of the Gramm-Rudman Budget Act, we strongly believe that the Department must allocate additional staff and resources to ensure that lender performance is adequately monitored. In addition, since MBA recognizes the difficulties associated with the implementation of enforcement actions on a program with a small number of participants, we recommend that HUD develop default thresholds which would limit the number of defaults a lender may have in its loan portfolio. This proposal would not only provide HUD with an automatic enforcement tool to regulate the coinsurance activity of specific lenders, but would also protect the Department from accepting new projects from lenders with high default percentages. We will be pleased to work with HUD concerning the development of thresholds and the appropriate sanctioning procedures, such as pre-closing review.

Mr. Secretary, in an effort to provide a financially healthy and administratively sound Multifamily Coinsurance program, MBA requests your immediate attention to these problems. We are appreciative of HUD's consideration of industry comments, and we look forward to further dialogue on these matters.

Very truly yours,

Ronald F. Poe

Ronald F. Poe

vad

EXHIBIT #2

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
THE SECRETARY
WASHINGTON, D.C. 20410

August 4, 1986

Mr. Ronald F. Poe
President
Mortgage Bankers Association
of America
1125 Fifteenth Street, NW
Washington, DC 20005

Dear Mr. Poe:

Thank you for your letter of July 8, 1986 about your concerns regarding the multifamily coinsurance programs administered by this Department.

I share your interest in the success of the coinsurance program and recognize that monitoring is a critical element in such a success. I have made additional commitments to this important Administration program objective. The FHA Commissioner's office has taken steps to increase the Housing organization's sensitivity and responsiveness to the coinsurance program. The number of staff having a full time involvement in coinsurance has been markedly increased. A new Coinsurance Division has been established which includes, as a separate entity, a Coinsurance Monitoring Branch. This Branch will specifically focus on the program's activity to insure that it is progressing in the best manner possible with top quality underwriting and servicing of coinsured loans. In this same regard, I have instructed the Office of Housing to hire five additional professional staff specialists to assist in this area of monitoring. Administrative resources, including travel funds, will continue to be made available to enable HUD staff to travel to coinsurance sites. These activities will enhance our monitoring efforts and continue to allow this important Administration priority to grow. This improved monitoring ability will aid us in giving the needed direction to lenders so that potential losses to the insurance fund can be avoided and/or reduced.

We have also moved forward in the area of data monitoring of the coinsurance activity through the use of new micro-computers and associated software. The software is especially designed to give our limited staff the tools to determine whether or not coinsurance underwriting is performed in the manner that we expect. In addition, this software will give us the ability to maintain timely reports and an overall data resource system for the active coinsurers.

Since the program became operational, we have actively monitored lender and field office submissions, endorsement packages, computer data input and other similar material to identify problem areas and programmatic improvements that could be made. We are continuing to actively monitor the coinsurers through large scale detailed on-site reviews. We have, in the past, through these reviews, taken steps to sanction coinsurers who we found to be performing in manners that were not envisioned by the program. In two instances, approved lenders were required to submit underwriting processing to HUD before issuing commitments until appropriate improvements were made. We fully intend to maintain this vigilance and will take whatever steps are necessary to keep the high quality of performance that will insure its continued success.

Also, your recommendation and offer of assistance regarding default thresholds will be considered. Your concerns and comments are helpful, timely and very much appreciated. We will continue to develop our capabilities and take the steps necessary to ensure an efficient and effective coinsurance program.

Very sincerely yours,

Sam

Samuel R. Pierce, Jr.

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

202-861-6500

Mortgage Bankers Association of America

FHA MULTIFAMILY COINSURANCE

The Mortgage Bankers Association of America (MBA) appreciates the opportunity to submit this paper on the multifamily coinsurance programs of the U.S. Department of Housing and Urban Development. It was prepared by the Coinsurance Subcommittee of MBA's Insured Project Committee. Its purpose is three-fold:

1. to provide comments on the advantages of the coinsurance programs as they relate to the provision of affordable multifamily rental housing in furtherance of national housing policy goals;

2. to relay industry concerns regarding the ongoing viability of the coinsurance programs; and

3. to provide suggestions for improving their overall quality.

THE MORTGAGE BANKERS ASSOCIATION OF AMERICA

The Mortgage Bankers Association of America is a national trade association representing more than 2,700 member mortgage companies, savings and loan associations, commercial banks, savings banks, life insurance companies and others involved in every facet of real estate finance. Our members originate and service more than 75 percent of the loans insured by the Federal Housing Administration (FHA) and approximately 40 percent of all residential mortgages nationwide. We are also active participants in the secondary market programs of the Government National Mortgage Association (GNMA).

THE INSURED PROJECT COMMITTEE

The 250 members of MBA's Insured Project Committee are actively engaged in the finance and delivery of multifamily rental housing insured by FHA and guaranteed by GNMA. The Committee studies and makes recommendations for improvements in all aspects of producing, financing and managing governmentally-insured multifamily loans. It also sponsors conferences and seminars designed to educate the industry on current and anticipated trends in multifamily housing, new policy initiatives and the technical aspects of underwriting, servicing and making project loans. The Committee has four standing subcommittees of which the Coinsurance Subcommittee is by far the largest and most active.

MBA's Coinsurance Subcommittee is dedicated to improving the quality and effectiveness of the multifamily coinsurance programs, and to ensuring their preservation. A large majority of the firms currently approved under the various FHA coinsurance programs are members of MBA and have representatives who are active members of the Subcommittee.

During the past year, the Subcommittee provided comments on the Department's proposed rule for the coinsurance of nursing homes and related facilities (many of its comments were incorporated into the final rule), assisted with the development of HUD's policy governing Section 223(f) market/submarket reviews, and initiated several meetings with the Department on a variety of issues pertaining to the coinsurance programs. In March of this year, the Subcommittee organized and sponsored the Multifamily Coinsurance Seminar which provided a forum for the exchange of technical information and advice concerning various aspects of coinsurance. HUD Coinsurance Division Staff and industry experts participated as speakers before more than 125 representatives of coinsurance firms on topics as diverse as underwriting, monitoring and loan management. The seminar was very well received, and will be expanded and repeated next year.

MBA's Coinsurance Subcommittee looks forward to a continuation of its proactive relationship with HUD on subjects of mutual concern in order to ensure the ongoing viability and integrity of the coinsurance programs.

THE BENEFITS OF COINSURANCE

The multifamily coinsurance programs of the Department of Housing and Urban Development provide unique opportunities for the public and private sectors to work together to deliver and preserve affordable multifamily rental housing for all income levels through a mechanism that permits shared risk and a more efficient use of limited resources. Under coinsurance, the responsibility for underwriting and servicing loans, and property disposition is delegated by HUD to the private sector. This has enabled HUD to reduce its budget and staffing requirements and, at the same time, provide a mechanism for more quickly and efficiently producing multifamily housing.

The Section 221(d) and Section 223(f) coinsurance programs are used extensively to maintain the supply of moderately priced multifamily rental housing, by providing long term, fixed rate financing. The fixed rate nature of the programs and the prepayment restrictions typically associated with the accompanying financing structures, generally encourage developers/owners of coinsured projects to maintain them as rental housing for a minimum of ten to twelve years. This contributes to greater stability in the rental housing supply, as well as in the investor markets.

Coinsurance programs also fill an important void in the financing options available to developers and owners of affordable multifamily housing. Many of the projects funded through the various coinsurance programs would not meet the requirements of the major life companies and savings and loan institutions that have been active as direct lenders in multifamily finance in recent years. These institutions are typically more interested in providing financing for properties that do not fall within the classification of low to moderate income housing. Furthermore, they will probably become even more selective with regard to the projects they are willing to finance because of the current crisis in the savings and loan industry and the new risk-based capital requirements.

The coinsurance programs have been used in conjunction with other HUD programs, such as Housing Development Grants, Community Development Block Grants, Urban Development Action Grants and Section 8 Rental Assistance, and with state and local funding programs to develop low to moderate income housing. In addition coinsurance has been used by both profit-motivated and nonprofit sponsors of multifamily housing as credit enhancement for tax-exempt bond financings which require a low income housing component, and in conjunction with projects utilizing low income tax credits. We would also expect coinsuring lenders to actively finance affordable rental housing units within enterprise zones.

The newly created Section 232 coinsurance program enables lenders to provide funding for housing for the elderly and special need groups. In addition to nursing homes, the program can be used to finance Drug and Alcohol Abuse Centers, and facilities for the homeless, battered women, AIDS victims, Alzheimer patients and others in need of psychiatric care.

Under coinsurance, lenders are able to attract developers who have more experience, greater financial strength and stronger projects typically than those that can be attracted under the full-insurance programs. Many of the better developers avoided the use of government programs in the past because of the time involved in processing their loans, typically 12 months or longer under full-insurance. Under coinsurance, however, the processing time is significantly reduced, thus allowing coinsuring lenders to better compete for the stronger projects and more experienced developers. Stronger developers and better projects reduce risk and make for a much healthier portfolio of insured multifamily loans.

INDUSTRY CONCERNS

MBA condemns the serious program abuses reported by the HUD Inspector General and the FBI. We believe these alleged instances of mismanagement and fraud should be dealt with as expeditiously as possible. However, we are concerned that in response to these allegations, the Department or Congress will impose unduly restrictive measures to the detriment of the coinsurance programs, the industry and the populations they seek to serve. The benefit of coinsurance as an effective means for the delivery of affordable multifamily rental housing in furtherance of national housing policy goals, should not be lost in the attendant negative publicity.

There is also concern that the Department or Congress may elect to shut down the coinsurance programs entirely, thereby unfairly penalizing all coinsuring lenders (and mitigating the positive aspects of the coinsurance programs) regardless of individually successful records. This is probably a natural reaction to programs experiencing difficulties. Instead of correcting problems and eliminating abuses, the temptation is to eliminate or suspend the program(s). This approach has, in the past, led to a cycle of programs that have never been given a proper chance to fully evolve. We believe that a more positive and productive approach is to work with existing programs to correct problems and eliminate abuses.

It is important to recognize that the coinsurance programs are still relatively new and, as with any new program, problems will arise which must be constructively addressed by all parties concerned to ensure the programs' integrity and ongoing viability. The coinsurance programs have been well received by the development and real estate industries, and should be given an opportunity to work. They have been shown to effectively provide production capacity, and are adaptable to new directions in affordable housing that may be contemplated in the future.

MBA recognizes that although there have been some program abuses by a small minority of coinsuring lenders under the various coinsurance programs, most lenders have healthy portfolios with few or no projects in default. In general, coinsurers are driven to underwrite good deals because a substantial amount of future income is derived through servicing. Mortgages that go into default cost lenders money. Violations and abuses that are permitted to go unchecked simply serve to damage all concerned and result in unacceptable losses.

RECOMMENDATIONS

MBA proposes that the Department consider the following recommendations for strengthening and improving the coinsurance programs:

1. Increased monitoring and more rigorous enforcement of program requirements: As in the past, MBA encourages the Department to develop an effective system for monitoring coinsuring lenders so that potential problems and abuses can be detected early on and corrective actions taken. We recommend on-site monitoring by the Department on a rotation basis. We also recommend the development of a rigorous enforcement policy to ensure compliance with program standards. Monitoring will only be effective if the Department takes quick action to enforce program standards and compliance. MBA is willing to assist the Department in the development of policies and procedures pertaining to monitoring and enforcement.

2. Increased staffing: We recommend that the Department staff the Coinsurance Division to ensure that new initiatives and effective monitoring are fully and properly implemented.

3. Joint coinsurance of project loans: We recommend that the Department give consideration to a policy that would allow coinsuring lenders to jointly coinsure large project loans. This would provide a mechanism for shared risk and a system of checks and balances in underwriting and managing loans. Furthermore, this would mirror the standard policy in the banking industry to participate out loans which are in excess of a bank's legal lending limits.

4. Reinsurance of project loans: Since it is in the best interest of the Department and the industry as a whole to maximize the financial capacity of coinsuring lenders, we recommend that the Department encourage the use of reinsurance by facilitating approval of reinsurance documents and by reducing the coinsuring lender's share of the risk when reinsurance is used. The use of reinsurance would provide an additional system of checks and balances in underwriting project loans because reinsurance agents would review the underwriting of each loan before agreeing to reinsurance it. Furthermore, reinsurance would provide an additional source of funds to cover project losses should they occur.

5. Programs for assisting with troubled projects: In cases where loans do become troubled, coinsurers should have available all of the resources available to lenders under the full-insurance programs. We recommend that coinsuring lenders be permitted to coinsure Section 241 supplemental loans and Section 223 operating loss loans. These would enable coinsurers to provide developers experiencing short term cashflow problems with a means to fund deficits and to recoup their capital contributions through second mortgages on the projects once they begin to generate income.

6. Continuance of the low income housing tax credit: MBA solicits the support of the Department in our effort to initiate legislation to extend the low income housing tax credit which is to be eliminated at the end of this year. Such credits can be used effectively in conjunction with coinsurance to provide affordable rental housing.

CONCLUSION

The MBA believes that coinsurance represents an effective partnership between the public and private sectors which, when appropriately utilized, assists the Department in fulfilling national multifamily housing needs. It is imperative that appropriate monitoring and enforcement be performed by the Department so that inappropriate lending practices by a few coinsuring lenders do not affect the integrity of the program as a whole. Such monitoring and enforcement programs must be designed so as to effectively curtail abuses, while still permitting lenders the ability and autonomy within departmental guidelines to utilize the coinsurance programs.

May 4, 1989

EXHIBIT #4

MORTGAGE BANKERS ASSOCIATION
OF AMERICA

June 20, 1989

Mr. Peter Monroe
Department of Housing and Urban Development
Office of Housing
451 Seventh Street, S.W./Suite 9100
Washington, D.C. 20410

Dear ~~Mr. Monroe~~ Peter:

The Mortgage Bankers Association of America would like to thank you for giving us the opportunity to meet with you and members of your staff to discuss the coinsurance programs. We would also like to thank you for hosting the recent "Town Meeting" on coinsurance. We are encouraged by your comments regarding your commitment to the coinsurance programs, and commend the Department on its intent to begin adequately monitoring coinsuring lenders, as was the intent when the programs were created. We firmly believe that effective monitoring (coupled with appropriate enforcement and sanctions, when required) will substantially eliminate the abuses that have been committed by a limited number of coinsuring lenders. We are hopeful that any program changes implemented as a result of your review will not serve to make the programs unworkable, but will serve to strengthen the overall quality of the coinsurance programs instead.

We would like to take this opportunity to provide comment and make recommendations on ways to strengthen and improve the overall quality of the coinsurance programs.

I. METHODS TO STOP COMMITMENT SHOPPING BY DEVELOPERS

You have raised legitimate concerns about the practice whereby developers shop coinsuring lenders for the most attractive loan amount and the lowest financing fees. We recognize that such shopping does occur, but suggest that competition among coinsuring lenders is not something that can or should be eliminated. We believe that it is unrealistic to conclude that lenders will come to identical conclusions about each and every project. We do recognize, however, that there should not be wide variations in the mortgage amounts assigned to a particular project by different lenders, given similar financing structures.

MBA
AT 75
READY FOR THE
FUTURE.

Shopping by developers for a coinsurer typically occurs before submission by the developer of a full application for coinsurance, and before payment of an application fee and completion of the appraisal process by the lender. Draft "underwritings" utilizing developer's assumptions are typically provided by coinsuring lenders only to the extent that rent and expense projections are not out of line with what a lender has seen in the marketplace. A developer then must decide whether to go forward with a particular lender based upon his comfort level with that lender's ability to perform, reputation, and anticipated funding levels, as well as the lender's experience utilizing the financing structure desired by the Borrower. It is at this point that developers submit an application.

We would agree that once a developer has submitted an application to a lender which results in submission by the lender to HUD of a request for any of the required reviews (e.g., market review, 2530 clearance), that HUD should not process any subsequent requests from an alternative coinsuring lender for reviews for the same project (as long as the same developer is involved) until such time as HUD receives either a withdrawal of processing from the first coinsuring lender that states the reason for termination of processing, or an explanation satisfactory to HUD from the new coinsuring lender as to the reasons for the change. This would mean that if a developer turns down an offer of financing, whether due to the lender's concern about the financial viability of the project or a developer's decision that he could obtain a higher mortgage from another lender, HUD would be so advised and could monitor any subsequent lender activity as it relates to the project in question. It is important to note, however, that there are any number of reasons why two lenders might arrive at differing underwriting decisions on the same project, and that this would not automatically be assumed to be poor underwriting on the part of the second lender.

II. METHODS TO CURTAIL OVER-MORTGAGING OF PROPERTIES ON THE BASIS OF UNSOUND APPRAISAL PRACTICES

We suggest that the focus for controlling appraisal quality should rest with the Review Appraiser and the Chief Underwriter. As you are aware, lenders are typically working within a broad geographical area and use a number of local appraisers on a limited basis. It is the responsibility of the Review Appraiser to (i) train each appraiser; (ii) verify the results of each appraisal; and (iii) assure that the underwriting is sound. As an additional backup, the Chief Underwriter is also required to concur in the decisions of the Review Appraiser. If the Review Appraiser and the Chief Underwriter are performing their jobs, even a bad appraisal should not result in excessive mortgaging.

We recommend that you implement a more stringent approval process for the Review Appraiser and Chief Underwriter positions, which would include not only a review of their individual resumes, but face-to-face interviews with technical staff at HUD and thorough reference checks as well. HUD may also want to add a requirement that either the Review Appraiser, Chief

Underwriter, or other qualified due diligence staff visit each site subsequent to receipt of the appraisal, and that such person also verify rent and expense levels as a part of the site visit.

If HUD discovers consistently bad appraisals on the part of a coinsuring lender, it should consider requiring a change in Review Appraiser and/or Chief Underwriter.

III. FLOOR/CEILING LOANS

While we recognize the attraction of a floor/ceiling loan concept, it is important to note that the FHA programs do not lend themselves to such a technique. In the conventional financing world, floor loans are typically set to cover 100% of a developer's cost, with a ceiling loan that would be available to provide developer's profit only if the project achieves specific income levels. In the Fannie Mae DUS program, which is value based, the floor loan is set based upon 80% loan-to-value and 1.15 coverage, but the developer can receive a 90% loan and a mortgage based upon 1.05 coverage as his ceiling if he is willing to put up an achievement escrow. A comparative analysis of the Fannie Mae DUS and Section 223(f) coinsurance programs is attached.

Under the Section 223(f) coinsurance program, which can be most easily compared to the Fannie Mae DUS program, the minimum coverage ratio is 1.1765, which is in excess of the base coverage requirement of Fannie Mae. The maximum loan-to-value ratio is 85%, which is obviously between Fannie Mae's floor and ceiling levels. There is an additional constraint in the mortgage calculation on a Section 223(f) loan that is not present under Fannie Mae. Under an acquisition, developers may only receive 85% of cost, which does not include any profit to the developer. In a refinance transaction, the developer can obtain the greater of 100% of cost (which includes only existing, non-identity-of-interest debt, and no equity take-out for the developer) and 70% of value. As illustrated by Attachment A to this letter, the result in the case of a refinance transaction where current debt is low is that current owners can not obtain the same mortgage amount that would be available on the same property in the event of a sale. This fact has led to abuses in the program, including over-valuing to bring 70% of value up to a level that is acceptable to the developer, and the creation of debt to bring the cost basis of the property up.

The maximum loan amount under the Section 221(d)(4) coinsurance program cannot exceed 90% of cost. In this instance, cost includes a builder/developer fee that contributes to, but does not fully cover, the inherent 10% equity requirement, and value (not cost) on the ground. It does not include marketing and lease up expenses or operating deficits, which must be borne by the developer. In rare instances, where the developer has either owned the ground for a long period of time or purchased it at less than fair market value, it is possible to cover 100% of cost (again, not including marketing and lease up expenses or operating deficits, or GNMA escrows), but this is exceedingly rare. Rather, developers are typically required to provide an equity contribution to bring the project to closing.

We believe that abuses by coinsuring lenders in the appraisal process can and should be curbed through effective monitoring and enforcement of program standards by HUD, rather than through the implementation of a floor/ceiling loan program.

IV. RETIREMENT SERVICE CENTERS

Although Retirement Service Centers (ReSCs) have not been discussed in any detail during the recent meetings we have had with HUD on the coinsurance programs, we want you to know that we will be making recommendations in the near future for improving the ReSC program. ReSCs are part of an evolving industry that developers, conventional lenders, coinsurers and HUD are just beginning to understand.

V. DEFAULTS AND WORKOUTS

We believe that coinsuring lenders should have available to them all of the tools available to lenders under the full-insurance programs to deal with troubled loans. Therefore, we make the following recommendations:

A. Partial Payment of Claims: In some instances, partial payment of claims, coupled with a recasting of the mortgage, could provide the necessary workout scenario for certain projects in default.

B. Earlier Loss Sharing: HUD should give consideration to an earlier sharing of losses, which would alleviate the significant financial drag that one or two defaults can have on a coinsurer's liquid reserves. This would also help to eliminate the need to simply close loans for upfront fees in order to make monthly GNMA investor payments, without regard for sound underwriting practices. Any such earlier sharing by HUD should be calculated to provide for the coinsuring lender to put in his initial 5%, as well as his portion of the split in any subsequent loss. This would likely involve the coinsuring lender making the first two or three payments, and then splitting subsequent mortgage payments on such a percentage as to assure that the lender has met his obligations. This would also provide the coinsuring lender with an incentive during the first few months to work out problems associated with the loan.

C. Section 241 Supplemental Loans and Section 223 Operating Loss Loans: We recommend that coinsuring lenders be permitted to coinsure Section 241 supplemental loans and Section 223 operating loss loans. These would enable coinsurers to provide developers experiencing short term cashflow problems with a means to fund deficits and to recoup their capital contributions through second mortgages on the projects once they begin to generate income.

These are very complex issues which warrant further study. We intend to provide you with additional, more specific recommendations regarding default, workout, and disposition procedures in the future.

VI. ADDITIONAL RECOMMENDATIONS

In addition to the recommendations stated above, we want to reiterate the following recommendations made in our May 4, 1989, postion paper to HUD on the coinsurance programs:

A. Increased monitoring and more rigorous enforcement of program requirements: As in the past, MBA encourages the Department to develop an effective system for monitoring coinsuring lenders so that potential problems and abuses can be detected early on and corrective actions taken. We recommend on-site monitoring by the Department on a rotation basis. We also recommend the development of a rigorous enforcement policy to ensure compliance with program standards. Monitoring will only be effective if the Department takes quick action to enforce policy to ensure compliance with program standards. Monitoring will only be effective if the Department takes quick action to enforce program standards and compliance. MBA is willing to assist the Department in the development of policies and procedures pertaining to monitoring enforcement.

B. Increased staffing: We recommend that the Department staff the Coinsurance Division to ensure that new initiatives and effective monitoring are fully and properly implemented.

C. Joint coinsurance of project loans: We recommend that the Department give consideration to a policy that would allow coinsuring lenders to jointly coinsure large project loans. This would provide a mechanism for shared risk and a system of checks and balances in underwriting and managing loans. Furthermore, this would mirror the standard policy in the banking industry to participate out loans which are in excess of a bank's legal lending limits.

D. Reinsurance of project loans: Since it is in the best interest of the Department and the industry as a whole to maximize the financial capacity of coinsuring lenders, we recommend that the Department encourage the use of reinsurance by facilitating approval of reinsurance documents and by reducing the coinsuring lender's share of the risk when reinsurance is used. The use of reinsurance would provide an additional system of checks and balances in underwriting project loans because reinsurance agents would review the underwriting of each loan before agreeing to reinsurance it. Furthermore, reinsurance would provide an additional source of funds to cover project losses should they occur.

VII. LIQUIDITY AND SOUND CAPITAL RESOURCES

With regard to liquidity and Sound Capital Resource requirements for participants in the coinsurance programs, MBA proposes the following:

MBA recognizes the need and adjust the Sound Capital Resource and liquidity requirements under the various coinsurance programs, and will support HUD in its efforts to determine adequate levels. We believe these requirements should be applied on an aggregate basis for all coinsurance programs under which a coinsuring lender is participating, rather than being tied to each program individually. We recommend that any dedicated account required by HUD remain under the control of the coinsuring lender, and that it be coupled with a commitment by the Department and MBA to pursue legislation to address currently onerous tax requirements on such accounts.

As an interim step, MBA would support increasing the overall requirements for all programs to those levels currently imposed under the Section 232 coinsurance program, subject to the limitations outlined above.

MBA also believes that it is imperative that coinsuring lenders be given adequate time to achieve any additional requirements in order to assure that loans in processing and current warehouse lines would not be affected.

We hope these recommendations and suggestions for improving and strengthening the coinsurance programs are helpful. Please feel free to contact us if you have any questions or would like additional information. We look forward to working with you on an ongoing basis to assure the continuing viability of the coinsurance programs.

Sincerely,

Robert M. O'Toole

ves
Enclosure

cc: Cathy Pharis, The Patrician Mortgage Company

Attachment A

COMPARISON OF REFINANCE AND ACQUISITION TRANSACTIONS UNDER SECTION 223(f)

Assuming that a developer owns an apartment property with a current market value of $7,500,000, and that he is contemplating either selling the property for $7,000,000 or refinancing to take our equity, the 223(f) program could provide the following mortgages:

ACQUISITION

Assumptions:

Purchase Price:	$7,000,000
Transaction Costs	350,000
Total Cost to Purchaser	$7,350,000
Net Operating Income	$ 800,000
Interest Rate, including MIP & amortization:	11%

Maximum Mortgage would be lesser of:

1. 85% of value	
$7,500,000 x 85% =	$6,375,000
2. Debt Service Mtg @ 1.1765 coverage	
$800,000 x 85% / 11% =	6,181,800
3. 85% of Cost	
$7,350,000 x 85% =	$6,247,500
RESULTING MORTGAGE IF ACQUISITION	$6,181,800

Attachment A

REFINANCE

Assumptions:

Current Debt	$4,500,000
Transaction Costs	350,000
Total Cost to Current Owner	$4,850,000
Net Operating Income	$ 800,000
Interest rate, including MIP & amortization	11%

Maximum Mortgage would be lesser of:

1. 85% of value

$7,500,000 x 85% = $6,375,000

2. Debt Service Mtg @ 1.1765 coverage

$800,000 x 85% = 6,181,800

3. Greater of:

a. 70% of value
$7,500,000 x 70% = 5,250,000

b. 100% of cost = 4,850,000 5,250,000

MAXIMUM MORTGAGE IF REFINANCE $5,250,000

Attachment B

COMPARISON OF 223(f) COINSURANCE AND FANNIE MAE DUS PROGRAMS

	223(f) COINSURANCE	FANNIE MAE DUS PROGRAM
1. PROJECT ELIGIBILITY		
Existing	Eligible	Eligible - must be 90% occupied
Moderate Rehab Required	Eligible	Eligible - must be 70% occupied with stabilized expected w/in 90 days of rehab
Recently Completed/Rehabbed	Must be three years old	Eligible - must be 70% occupied, with 90% expected w/in 180 days of close
Commercial Space Allowed	Maximum 20% of space/income	Maximum of 20% of space and/or income
Minimum Loan Size	N/A, although most Lenders use approx. $3,000,000	$ 1,000,000
Maximum Loan Size	Not applicable	$50,000,000
2. MODERATE REHABILITATION		
Minimum Rehabilitation	Not applicable	Greater of $3,000 or 5% of mortgage
Maximum Rehabilitation	Greater of $6500 x high cost factor or 15% post rehab value	Lesser of $10,000 or 25% of mortgage
Escrow Required	100% cash escrow plus 50% cash or LOC overcollateralization	150% cash or letter of credit escrow
3. DETERMINATION OF MAXIMUM MORTGAGE		
Acquisition - least of:	a. Statutory mortgage limit b. Debt service coverage @ 1.1765 c. 85% of value d. 85% of cost	a. Statutory mortgage limit b. Debt service coverage @ 1.05-1.15 c. 80-90% of value d. 115%-135% of base loan amount
Refinance - least of:	a. Statutory mortgage limit b. Debt service coverage @ 1.1765 c. 85% of value d. Greater of:	a. Statutory mortgage limit b. Debt service coverage @ 1.05-1.15 c. 80-90% of value d. 115%-135% of base loan amount

Attachment B

4. CAPITALIZATION RATE		
GNMA/FNMA Coupon	9.750000%	9.250000%
GNMA Guarantee & Servicing	0.250000%	N/A
FNMA Servicing (Estimated)	N/A	0.250000%
Amortization	0.316069%	0.359339%
Mortgage Insurance Premium (Est)	0.600000%	N/A
	---------	---------
Capitalization Rate	10.916069%	9.859339%
Balloon	None	7-10-15 Years (Above rate assumes 10 years)
Discount Required @ 06/19/89	0.96%	1.050%
5. STATUTORY MORTGAGE LIMITS	Basic 223(f) limits x local high cost factor. Can get waiver up to 240%.	125% of basic 223(f) limits. 240% of basic 223(f) limits for HUD designated high cost area
6. OPERATING DEFICIT ESCROW	100% of Lender's estimate of deficits	150% of Lender's estimate of deficit
7. REPLACEMENT RESERVE REQUIRED	Yes	Yes, but may be waived by Lender
8. SECOND MORTGAGE PERMITTED?	Up to 7.5% of value, depending on amt. cash developer has invested. Secured by Surplus Cash Note.	So long as project maintains minimum 1.05 coverage, and total debt does not exceed value
9. PARTICIPATING LOANS AVAILABLE?		
- Below market interest rate	125-150 basis points below market for 25% participation	100-125 basis points below market for 25% participation
- Equity participation	Approximately 15% of value for additional 25% participation	Not currently available

a10B

Senator **Graham**. Realizing that we are here to talk about coinsurance, and particularly about how it relates to the section 8 Moderate Rehabilitation Program, I am going to start with questions on the basic philosophy behind FHA insured multifamily mortgages.

Through your experience, have you personally, through your firms, dealt with FHA insurance on multifamily projects?

Ms. **Beasley**. Oh, yes, sir. Most of our business is with FHA as fully insured or coinsurance loans.

Senator **Graham**. Have you also had experience of multifamily projects which were financed without FHA insurance?

Ms. **Beasley**. We have financed a number of projects through the Federal National Mortgage Association.

Senator **Graham**. For two similar projects, what would be the difference in financing costs that is a function of whether it is FHA insured or not?.

DIFFERENCE IN FINANCING COSTS

Ms. **Beasley**. You are talking about the financing fees that the lender charges?

Senator **Graham**. If I am at the developer's side of the table and I am trying to put together all of my costs from which I will then determine whether this is a viable project or not, what difference does it make to me whether I am eligible for FHA insurance on the mortgage or not?

Ms. **Beasley**. Well, the conventional lenders, the thrifts—and many of them have left the business of multifamily lending recently—but the thrifts that are still involved and the life companies generally finance a different type of property.

The life companies in particular want only top quality luxury rental housing. The thrifts charge generally lower up-front fees, in the range of a point or a point and a half, to put the loan on the books, but then they charge a significant spread each year, ranging anywhere from 150 up to 250 basis points, or 2.5 percent over the Treasury rate or their cost of funds. It might be 250 basis points over 5-year Treasuries, for example, or 175 basis points over their cost of funds from the Federal Reserve.

Senator **Graham**. And how would that compare with the rates charged for an FHA insured mortgage?

Ms. **Beasley**. The coinsurers generally charge higher up-front fees. We need to differentiate what is allowed under the program and what is being charged, because I think the press in particular has picked up on what is allowed and they see it as a very lucrative fee structure.

For existing projects, 223(F) projects, generally the market is about two points for the financing fee up front, and then the lender gets a share of the mortgage insurance premium that is paid every year. It can range from 10 basis points to 35 basis points. The rest of that MIP goes to HUD for new construction properties where the lender is providing both the construction and the permanent loan. The up-front fees are generally about 2½ points.

Now on top of the financing fees, there is a three-tenths of 1 percent application fee, which goes to cover the costs of the appraisal, the architect's review, the mortgage credit review, and other reviews required by HUD. In addition, if it is a new construction property, there is one-half of 1 percent allowed to cover the cost of sending our architects out to inspect the property twice each month during the construction period.

Senator GRAHAM. What would be the typical interest rate on the mortgage if it were insured? You have already given what would be a standard if it were not insured.

Ms. BEASLEY. Most of our loans are funded through the issuance of Ginnie Mae mortgage backed securities. So those rates of course change hourly. Today, we are in the range of 10 percent for the Ginnie Mae mortgage backed security, and then we have to add the mortgage insurance premium on top of that.

The life companies and Fannie Mae are in the range of about 9.5 percent, primarily for existing properties, not for properties that involve new construction risks.

Senator GRAHAM. Putting that all together, it sounds to me that what you have said is that the initial costs of FHA-insured multifamily mortgages are somewhat higher than the initial costs of a conventional mortgage originated through a banker or an S&L.

Ms. BEASLEY. That is right, sir.

Senator GRAHAM. What would be, in using the communities with which you are familiar, a going rate of differential on the interest on the mortgage?

Ms. BEASLEY. The ongoing interest on the mortgage, generally most of the thrift companies' loans, float. At best, they will fix a rate for 5 or 7 years. For example, for a good client, our rates are fixed for 35 years or 40 years.

Generally, I would say they average as high, or perhaps higher, than the thrift rate overall. But the spread to the coinsurer is much lower. The base rate is higher than is going to the Ginnie Mae investor, because he is buying a long-term investment.

Senator GRAHAM. I am coming back. I am trying——

Ms. BEASLEY. It is a difficult issue.

Senator GRAHAM. I am trying to get some economics to support the statement that you made, which indicates that if these insurance programs were not available, serious negative things would happen to the availability of multifamily housing. The numbers do not seem to support that.

If the cost of origination and the cost of carrying the mortgage are more or less the same, and we have not gotten to the fact that when we are dealing with section 8 we are talking about mortgages that are supported by guaranteed Federal rent roll for 15 years, what is the Federal Government contributing toward making housing more available for low income Americans?

Ms. BEASLEY. There are two issues here. First is, under the (D)(4) coinsurance program it is really the only constantly available source of funds where the developer can fix the rate today before he starts construction, and have it fixed through construction and for the permanent loan thereafter.

ELIGIBILITY OF THE LOAN

But the primary issue is the eligibility of the loan itself. The life insurance companies are not interested in standard bread and butter multifamily loans. They are not interested in loans that serve moderate income individuals. They have to maximize their yield, and they do so.

The thrifts have done more moderate income financings than the life insurance companies, but they are pulling back from multifamily lending in a very substantial way, due to the risk-based capital rules. They have also been in and out of the market, and normally tried to have floating refinancing, which makes it difficult for a developer to fix rents at a moderate level and keep them there.

So it is a question of which markets are being served by which type of lender. Since the 1937 Housing Act, where full insurance was implemented for multifamily projects, low and moderate income projects have been served primarily through FHA-insured loans.

Senator GRAHAM. So you are saying that it is not just a matter of comparing——

Ms. BEASLEY. It is not just cost.

Senator GRAHAM. It is an availability question. Without the FHA insurance, this category of multifamily projects would not be financed.

Ms. BEASLEY. That is correct, sir.

Senator GRAHAM. Turning now to the specific issue of the role of coinsurance, I was interested in the list which was contained in the May 1989 recommendations, which appear starting on page 8 of your testimony. These focus on what needs to happen within HUD in order to do a better job of evaluating its responsibilities and monitoring the program.

It seems to me that there is a systemic problem of a basic conflict of interest, of having the coinsurer then take on the role of being the underwriter so that the coinsurer is making the judgment as to the amount of the mortgage and the amount of the fair market rents which will support the revenue stream behind that mortgage.

Don't you consider that to be a defect in the program?

Ms. BEASLEY. No, I do not, Mr. Chairman. Coinsurance came about because the HUD field offices were so deteriorated through lack of staffing that they could no longer perform in a timely fashion. Interest rates are going up and down; developers have to be able to get their loans insured and be able to get them funded in an efficient manner.

If HUD monitors the program correctly, if they check each loan that each coinsurer underwrites and quickly move to sanction lenders that are doing a bad job in underwriting, get them out of the program—the responsible lenders in the program want that—and if it works that way, it greatly leverages the HUD staff's time. It expands the amount of secondary capital that can flow into housing in an efficient way.

But it has to be done promptly, HUD needs the staff to do it. HUD needs to have the political will to sanction coinsurers and I believe that that was absent before.

I am very impressed with the new team that Mr. Kemp has brought in, and I can see that they are spending many, many hours trying to find the answers. I think they will make the program work.

Senator **Graham**. Looking at the report this morning by the inspector general of the projects which were evaluated, which represent approximately 20 percent of all of the projects that have been coinsured, the section 8 Moderate Rehabilitation projects, the estimate is that the mortgages were excessive by $22 million and that the rent subsidies are and will be excessive by $37 million.

You could have hired a lot of appraisers and overseers to have run this program and avoided the conflict of interests for those kinds of dollars.

Ms. **Beasley**. I think we need to separate the problems of the Mod Rehab Program from the problems of coinsurance. Understand, please, that most of the Mod Rehab projects were done by one coinsurer. That is a separate issue, and I am not really prepared to comment on it beyond saying, please separate the two programs in your thinking.

Senator **Graham**. Well, looking specifically at the coinsurance program as applied to Mod Rehab, do you have any recommendations for either administrative or congressional action to try to make it less subject to abuse?

Ms. **Beasley**. I think the action that Secretary Kemp is taking now, which is having the HUD field offices set the fair market rents, will go a long way towards stopping any abuses that may have occurred in that program.

Senator **Graham**. Ms. Beasley, thank you very much. I appreciate your patience in waiting so long to testify. I wish to thank you and thank the association for their excellent contribution.

Ms. **Beasley**. Thank you for the opportunity.

[The witness was excused.]

Senator **Graham**. If there is no further business, the committee is adjourned.

[Whereupon, at 1:06 p.m., the committee was adjourned.]

ABUSES IN THE SECTION 8 MODERATE REHABILITATION PROGRAM

FRIDAY, SEPTEMBER 29, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Bob Graham presiding.

Present: Senators Graham, Garn, Sarbanes, Dixon, Heinz, Pressler, and Cranston.

OPENING STATEMENT OF SENATOR GRAHAM

Senator **GRAHAM**. We will call the meeting to order.

Before we begin the hearing this morining, I would like to announce for the record that as members arrive we will be recording their votes on three nominations pending before the committee and one bill, S. 1091, U.S. Coast Guard Bicentennial Medal Act.

The nominations on which we are voting are Richard Schmalensee, to be a Member of the Council of Economic Advisers; Eugene Kistler Lawson, to be First Vice President of the Export-Import Bank of the United States; and Claire E. Freeman, to be Assistant Secretary of Housing and Urban Development.

We will begin the period for voting now, and it will extend until the hearing concludes. When a quorum is established, a final vote will be announced. We will adjourn, and matters will be reported to the full Senate today.

Today we are continuing the investigation into the Department of Housing and Urban Development's Moderate Rehabilitation Program. Our hearing this morning is the last in a series of three hearings held during the past few weeks focusing on the cheeses that attracted the rats inside and outside of Government to milk the Mod Rehab Program.

I am not certain that the rats, the milk, and the cheese—I apologize for the mixed metaphor. [Laughter.]

Throughout the course of these hearings it has become apparent that the layering of subsidies was a prime source of abuse. Earlier testimony has indicated that due to lack of oversight and coordination among Federal, State, and local agencies administering financial assistance many Mod Rehab projects received more benefits than required to encourage private investment.

Thus far, we have examined the roles of fair market rents and coinsurance. Today we look at the low income housing tax credit.

Since the low income housing tax credit was enacted, it has become a powerful and important tool for attracting equity for low income housing; however, when the program was enacted in 1986 few could have envisaged that the tax credit would be used in conjunction with the Mod Rehab Program.

As the inspector general, GAO, and others have reported, the combination of these subsidies resulted in overly enriched contracts and inflated profits.

The low income tax credit will continue to play a leading role in providing housing opportunities for low income families.

As testimony before the committee has indicated, there needs to be greater oversight on the management of the tax credit at the State and Federal level. At a time when Federal funding for housing is desperately at low levels we must work to assure the resources devoted to help the poor are not squandered, mismanaged, or end up lining the pockets of the overly enriched.

Senator Garn, do you have an opening statement?

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Very briefly, Mr. Chairman. Thank you.

I am pleased to join in this third day of hearings on the Moderate Rehab investigation hearings. A recent report by the HUD inspector general indicates that the Federal housing assistance was certainly not used efficiently. As a matter of fact, in this Senator's opinion, it was disgraceful what has gone on.

Section 8 rental assistance and tax credits were provided for many Moderate Rehab projects, and there were two separate Federal subsidies. At a time when there is scarce resources, we should maximize Federal spending, not squander it in the way that it has been.

Senators Mitchell and Danforth have devised legislation, S. 980, which will hopefully rectify the problem. This legislation ensures that tax credits will be allocated based on needs, merit, and legislation has been incorporated into the Senate reconciliation package.

I look forward to working with Senators Riegle and Graham and the Finance Committee so that Federal dollars are used more effectively and efficiently.

I apologize, Mr. Chairman, and to your witnesses for having to leave, but I am sure you are all aware that this is the silly season in Congress. That simply means that September we are going through our usual throes of trying to finish appropriations bills by September 30, which is tomorrow. We have the last one on the floor. I am a member of the Appropriations Committee and on five separate subcommittees, three of which are in conference at this time.

So I look forward to reading your testimony, and I thank you for coming.

The Senator from Florida said it was all right if I left as long as I took care of his Florida projects in the Interior. [Laughter.]

Senator GRAHAM. I indicated that it can be by noon.

Senator GARN. I will take care of the Utah projects, too. [Laughter.]

Senator GRAHAM. Before we begin I have statements from Chairman Riegle and Senator Dixon to be inserted in the record.

STATEMENT OF SENATOR ALAN J. DIXON

Senator DIXON. Mr. Chairman, this is the fourth in a series of hearings to investigate HUD's section 8 Moderate Rehabilitation Program. It will focus on low-income housing tax credits, the only remaining Federal tax incentive program whose intent is to produce low-income housing.

Since I am a co-sponsor of S. 980, I have a very special interest in this hearing. S. 980 is a bill to repeal the December 31, 1989, expiration date of the low-income housing Tax Credit Program and to make a number of changes to improve the effectiveness of the program.

Mr. Chairman, I look forward to hearing from our witnesses today and will give serious consideration to any recommendations that would improve the Tax Credit Program, a program which is crucial to our Nation's poor who so desperately need affordable places to live.

Thank you, Mr. Chairman.

STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

Chairman RIEGLE. Our hearing this morning is the last in a series of three focusing on the Mod Rehab Program and how it's use in conjunction with other Federal programs and subsidies made Mod Rehab ripe for abuse. In our first hearing, we examined how problems in calculating the rents for Mod Rehab projects allowed rents in excess of prevailing rents to be charged for Mod Rehab projects. And in our hearing yesterday, we examined the role of coinsurance and saw how HUD allowed coinsurers of Mod Rehab projects to establish both the section 8 rental rates and the insured mortgage amounts.

The focus of our hearing this morning is on the use of the low income housing tax credit with the Mod Rehab Program.

In the last 3 years, the low income housing tax credit has become a major and effective tool for the production of low income housing. Since enacted as part of Tax Reform, the tax credit has helped to produce nearly 200,000 units of low income housing. And demand for the credit is on the rise. In 1987 less than 20 percent of the available credits were allocated. That figure rose in 1988 to 66 percent, and I am informed that we expect to use all of the available credit to be used in 1989.

In April of this year, the Inspector General reported that HUD had "yet to establish policies and procedures to deal with the potential effect of low income housing tax credits on the contract rents for mod rehab projects." As a result, the IG concluded that the effect was to allow many project owners obtaining the credit to receive significant profits from such allocations.

In testimony before the committee on August 2nd, the GAO confirmed the IG's earlier observation and testified that "by combining proceeds from the sales of income tax credits with coinsured mortgage loans secured by moderate rehabilitation subsidies, developers were able to generate sizeable cash proceeds."

As we begin today's discussion about mod rehab and the low income housing tax, I think it is important to note that the low income housing tax credit, coinsurance, or fair market rents are not the causes of the abuse of the Mod Rehab Program. Rather, it was the interaction of these programs, coupled with the lack of oversight and mismanagement by HUD officials that allowed these programs to become the vehicles by which developers could reap excessive profits.

I look forward to hearing from each of our witnesses this morning and to hearing from them how we can best structure these programs to assure that scarce Federal resources devoted to housing low income families are not squandered through fraud, abuse, or mismanagement.

Senator GRAHAM. As we have done in our previous hearings, I would like to swear the witnesses before we commence the testimony.

Mr. Ols, would you please stand and raise your right hand?

[Witness sworn.]

Senator GRAHAM. Mr. Ols, Director of Housing and Community Development Issues Resources, Community and Economic Development Division of the General Accounting Office.

STATEMENT OF JOHN M. OLS, JR., DIRECTOR OF HOUSING AND COMMUNITY DEVELOPMENT ISSUES—RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY DENNIS FRICKE, ASSISTANT DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES—RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, GAO, RICHARD GREENE, EVALUATOR-IN-CHARGE, HOUSING AND COMMUNITY DEVELOPMENT ISSUES—RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, GAO; AND MARGARET L. ARMAN, COUNSEL, OFFICE OF THE GENERAL COUNSEL, GAO

Mr. OLS. Thank you, Mr. Chairman.

I would like to introduce my colleagues that are with me today.

To my right is Dennis Fricke, who is the Assistant Director on this particular assignment.

To my left is Ric Greene, evaluator-in-charge. He did the detailed analysis on the follow-up as well as our earlier testimony in August.

And to his left is counsel from our Office of General Counsel, Marge Arman.

Mr. Chairman, I would like to just move through my statement. I will summarize some parts, skip some parts.

If I can ask that it could be introducted in the record in its entirety?

Senator GRAHAM. Without objection, it is so ordered.

Mr. OLS. We appreciate the opportunity to assist the committee in identifying ways to improve the use of section 8 Mod Rehab and Tax Credit Programs so that more low-income families will benefit.

As you know, we testified before the committee on August 2, 1989 on how these two programs had been used in combination to generate substantial cash proceeds to developers on eight projects that we reviewed.

This morning I will highlight key points from my earlier testimony, comment on our preliminary findings regarding the impact on low income families when the Mod Rehab Program together with tax credits are not used efficiently and provide our observations on S. 980, which is intended to improve the effectiveness of the Low Income Housing Tax Credits.

In summary, we testified earlier that the lack of centralized review of the total amount of financial assistance awarded to individual projects enabled developers to realize cash proceeds far greater than the cost of acquiring and rehabilitating the projects.

In addition, our preliminary results since that time, at your direction to follow up on the effect on those particular inefficient uses, and what we found is that in very weak housing markets you have a problem in these two programs when these two programs come together. The problem is the impact on the residents and a benefit to the developers of those projects.

Finally, S. 980 should improve the effectiveness of the Tax Credit Program, but we believe the bill requires clarification of certain project selection factors.

Also, the bill does not address the use of tax credits in markets where economic conditions have created a housing surplus.

The Moderate Rehabilitation and Tax Credit Programs were intended to increase the supply of units for low income families. Under the Moderate Rehabilitation Program, owners agreed to upgrade substandard rental housing in exchange for 15 years of guaranteed, project-based section 8 rental subsidies. Certain developers have coupled the Moderate Rehabilitation Program with tax credits.

In my earlier testimony, I stated that developers were able to generate sizable cash proceeds by combining proceeds from the sale of income tax credits with coinsured mortgage loans that are secured by moderate rehabilitation rent subsidies. Tax credit awards for the eight projects ranged from a low of about $896,000 on one project to a high of about $5.8 million on another.

In attachment 1 we have listed the tax credits which go with each of the projects that we analyzed.

This situation evolved because different administering agencies awarded multiple forms of financial assistance to eligible projects. With HUD, state tax credit allocation agencies, and local governments all allocating the assistance, there was little or no centralized oversight of the total financial assistance package provided to individual projects. It is our opinion, as well as that of HUD's Office of Inspector General, that under this practice some projects received more financial assistance than necessary to encourage the rehabilitation of housing projects.

To the extent that developers profited substantially from rehabilitating the projects, it was clearly at the expense of assisting additional low income families. However, it is very difficult to measure the precise impact on low income families because no benchmarks exist on what should be an acceptable developer profit.

As we heard from the gentleman from California, Mr. Rousseau used a figure of 5 percent. Others talked about 10- to 15-percent profit, but there is no guidelines. The eight projects that we analyzed we know were substantially above those figures.

Despite how disturbing it may be that some developers realized substantial gains on their limited investments, also troublesome is that five of the eight projects we looked at were rehabilitated in weak to very weak housing markets where rental housing was frequently in oversupply relative to demand.

Given what we have found, the Moderate Rehabilitation and Tax Credit Programs are most helpful in housing markets with a shortage of rental housing. In housing markets with an adequate supply of rental housing, but where the problem is one of affordability, then the use of the existing housing supply with tenant based section 8 housing certificates or vouchers becomes a preferred, more effective, and less costly form of assistance. Certificates and vouchers subsidize the rent payments of low-income households in existing privately owned housing by paying a portion of recipient's actual rents.

In August, the committee asked us to assess the impact of the inefficient use of the Moderate Rehabilitation and Tax Credit Programs on the number of housing units available to low-income families. We have been gathering data from the market areas in which the eight projects are located, and although we regretfully will take another 4 to 6 weeks before our work is complete, I would like to share with the committee this morning some of our preliminary findings.

I will use a project that was rehabilitated in Denver, CO, known as Sierra Vista, to illustrate these findings.

The Sierra Vista project provided 209 subsidized units. Like other developers, the Sierra Vista developer combined the Moderate Rehabilitation with tax credits. Upon completion of the project a two-bedroom unit rented for about $600 per month. This rent level was approved by HUD to cover operating costs and to service the debt incurred in acquiring and rehabilitating the project. The rent also met HUD's fair market rent guidelines.

When this market was placed in service, the Denver rental marked was very weak, with an 11 to 14 percent vacancy rate, and two-bedroom apartments on the open market rented for about $450 per month, or $150 less than at the Sierra Vista project. Given the market conditions in Denver, use of existing suitable, vacant housing with section 8 certificates or vouchers would have been the preferred means of assisting low income families. We believe these programs would have been preferable because significantly more subsidized units could have been provided with the Federal funds expended.

Using what we believe to be conservative assumptions, we estimated the total Federal subsidy for this project to be about $23 million over the 15-year duration of the subsidy. This $23 million is made up of $5 million in tax credits and $18 million in rental subsidies over the 15-year period.

Attachment II shows our calculation of Federal expenditures per unit for the Sierra Visa project. The Federal subsidy for this project equates to a present value per unit of about $58,000 in comparison to a $36,000 per unit Federal subsidy for private rental housing in the same market.

Expending the same amount of funds but relying on the existing housing supply in Denver and using section 8 certificates and vouchers, the Government could have subsidized 128 additional units. This figure represents about 60 percent more units than were actually subsidized in the Sierra Vista projects.

As you know, low income housing tax credits are set to expire at the end of this calendar year. There are currently several bills pending that would extend the tax credit authority. Although some of the problems we reported in our August testimony would tend to be self-correcting as States gain experience in tax credit allocation and as increasing competition for available tax credits permits states to be more selective in their allocation of credits, we believe it may be appropriate to amend the law as well as extend it. S. 980, now before the Finance Committee, would address many of the issues we have identified. The most important features of the bill are highlighted below.

You may recall that we recommended in our earlier testimony that a central authority be designated to review the tax credits as one part of a total financing package for low income housing. S. 980 gives responsibility for coordinating and overseeing the tax credit program to the State housing credit agencies. It directs those agencies to develop formal plans for allocating their available tax credits among competing qualified projects. The bill specifies general criteria for the preliminary screening of tax credit applications and gives priority in the final selection to projects, one, serving tenants with the lowest incomes, two, serving tenants over the longest period, and, three, producing the most units for the least tax expenditure.

An advantage of this last selection factor is that it encourages States to carefully review developer costs and to allocate tax credits to projects that are most cost efficient.

However, this factor may need further clarification because it could override the other two selection factors. To illustrate the potential conflict, we should consider the newly authorized tax credits on single room occupancy dwellings and the stepped up basis, the amount upon which the credit is based, available to be applied to development activities in high building cost or extreme poverty areas.

If maximizing the number of units were the overriding selection criterion for allocating credits, single room occupancy buildings would invariably be preferred because they provide the most units per credit dollar. However, single room units may not meet community needs for family housing.

Similarly, bonus tax credits, intended particularly to stimulate development activity in high building cost or extreme poverty areas, would almost never be made available because they produce fewer units per credit dollar, even though such development may be the State's most critical need.

Another feature of S. 980 intended to improve efficiency is the requirement that a State consider the total financing available to a particular low income housing project. Under this provision the State would examine other sources of State and Federal funds and other tax benefits provided to specific projects. With the total financing picture in view, the State would be permitted to allocate only the amount of tax credit it determines is actually needed to ensure the financial feasibility of the particular undertaking and to ensure the long-term viability of the project as low income housing.

While the statutory selection criteria and allocation factors are mostly general, we believe that the States' motivation to get the most out of this housing finance option will probably help ensure that at least the minimum requirements are met.

In addition the bill would also increase competition for tax credits by expaning their availability to include buildings acquired from HUD and the Farmers Home Administration. Another change would liberalize the current restrictions on credits for federally subsidized buildings. In areas where high building and operating costs and the extremely low incomes of potential tenants otherwise discourage development and rehabilitation, the bill would permit a stepped up basis—130 percent—to be applied to buildings in these areas. This would yield bonus tax credits and could attract development.

The bill's final eligibility expansion would make tax credits available for the first time to single room occupancy, special needs housing projects, and small owner occupied buildings.

In addition, the bill permits a 1 year carryforward of unused tax credits. This carryforward eliminates the "use or lose" aspect of the previous legislation and encourages the more selective allocation of available credits. Nonetheless, we expect that the demand for tax credits will far exceed the credit ceiling allowable in most States. In this regard, tax credits alone cannot solve the problem of providing sufficient affordable housing for low income families. There will still be a need to continue other housing subsidies for construction and occupancy at all levels.

Finally, with some limited exceptions relative to foreclosures, the bill would double the current 15-year commitment to keep the property available for low income housing. This provision would improve the return on the public's heavy investment in tax credits.

To us, these provisions of S. 980 appear responsive and can address the problems and inefficiencies encountered in administering the Tax Credit Program thus far. We believe the Congress should continue to monitor how State agencies are implementing these provisions so that these of problems do not occur in the future.

However, the bill does not address the specific problem of using tax credits to produce housing in markets that have surplus rental units. A basic purpose of tax credits is to incease the production of housing units. But in some States housing market exist in which economic conditions have created a housing surplus.

As we have noted, in such markets more families could be served if they were provided with section 8 certificates or housing vouchers to help them afford to live in the rental housing that already exists. The Congress may wish to consider restricting the use of tax credits in markets where vacancy rates in suitable housing are high.

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or members of the Committee may have.

[The complete prepared statement of John M. Ols, Jr., follows:]

United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
10:00 a.m. EDT
Friday,
September 29,
1989

Improving the Efficiency of Federal Housing Subsidies

Statement of

John M. Ols, Jr., Director, Housing and
Community Development Issues
Resources, Community, and Economic Development
Division

Before the
Committee on Banking, Housing, and
Urban Affairs
United States Senate

Mr. Chairman and Members of the Committee:

We appreciate the opportunity to assist the Committee in identifying ways to improve the use of the Section 8 Moderate Rehabilitation and Tax Credit Programs so that more low-income families will benefit. As you know, we testified before the Committee on August 2, 1989, on how these two programs had been used, in combination, to generate substantial cash proceeds to developers on eight projects that we reviewed.[1] This morning I will (1) highlight key points from my earlier testimony, (2) comment on our preliminary findings regarding the impact on low-income families when the Moderate Rehabilitation Program together with tax credits are not used efficiently, and (3) provide our observations on S. 980, which is intended to improve the effectiveness of the low-income housing tax credit.

In summary, we testified that the lack of centralized review of the total amount of financial assistance awarded to individual projects enabled developers to realize cash proceeds far greater than the cost of acquiring and rehabilitating the projects. In addition, our preliminary results of on-going work demonstrates that it is inefficient to use the Moderate Rehabilitation Program with tax credits in weak housing markets. Finally, S. 980 should improve the effectiveness of the Tax Credit Program, but we believe the bill requires clarification of certain project selection factors. Also the bill does not address the use of tax credits in markets where economic conditions have created a housing surplus.

---

[1] Project Developer Cash Flows Under HUD's Section 8 Moderate Rehabilitation Program (GAO/T-RCED-89-58).

NEED FOR CENTRALIZED REVIEW OF FINANCIAL ASSISTANCE

The Moderate Rehabilitation and Tax Credit Programs were intended to increase the supply of units for low-income families. Under the Moderate Rehabilitation Program, owners agreed to upgrade substandard rental housing in exchange for 15 years of guaranteed, project-based Section 8 rental subsidies. Certain developers have coupled the Moderate Rehabilitation Program with tax credits.

In my earlier testimony, I stated that developers were able to generate sizeable cash proceeds by combining proceeds from the sales of income tax credits with coinsured mortgage loans that are secured by moderate rehabilitation rent subsidies. Tax credit awards for the eight projects ranged from a low of about $896,000 on one project to a high of about $5.8 million on another. Attachment I to my statement provides the names and locations of these projects along with financial data pertinent to each one. When the developers sold their ownership interests in these projects along with the related tax credits, and when these proceeds were combined with mortgage loans and other sources of funds, the developers realized cash proceeds far greater than the costs associated with acquiring and rehabilitating the properties. We estimated cash flows to developers on the eight projects ranged from about $254,000 for a 36-unit project to about $2.1 million on a 352-unit project. On a per-unit basis, the range was from about $3,500 to $11,400.

This situation evolved because different administering agencies awarded multiple forms of financial assistance to eligible projects. With HUD, state tax credit allocation agencies, and local governments all allocating the assistance, there was little or no centralized oversight of the total financial assistance package provided to individual projects. It is our opinion, as well as that of HUD's Office of Inspector General, that under this practice, some projects received more financial assistance than necessary to encourage the rehabilitation of housing projects.

IMPACT ON LOW-INCOME FAMILIES

To the extent that developers profited substantially from rehabilitating the projects, it was clearly at the expense of assisting additional low-income families. However, it is very difficult to measure the precise impact on low-income families because no benchmarks exist on what should be an acceptable developer profit. Despite how disturbing it may be that some developers realized substantial gains on their limited investments, also troublesome is that five of the eight projects we looked at were rehabilitated in weak to very weak housing markets where rental housing was frequently in oversupply relative to demand.

Given what we have found, the Moderate Rehabilitation and Tax Credit Programs are most helpful in housing markets with a shortage of rental housing. In housing markets with an adequate supply of rental housing, but where the problem is one of affordability, then the use of the existing housing supply with tenant-based Section 8 housing certificates or vouchers becomes a preferred, more effective, and less costly form of assistance. Certificates and vouchers subsidize the rent payments of low-income households in existing, privately-owned housing by paying a portion of recipients' actual rents.

In August, the Committee asked us to assess the impact of the inefficient use of the Moderate Rehabilitation and Tax Credit Programs on the number of housing units available to low-income families. We have been gathering data from the market areas in which the eight projects are located, and although we expect it will take another 4 to 6 weeks before our work is complete, I would like to share with the Committee this morning some of our preliminary findings.

I will use a project that was rehabilitated in Denver, Colorado, known as Sierra Vista, to illustrate these findings. The Sierra Vista project provided 209 subsidized units. Like other developers, the Sierra Vista developer, combined the Moderate Rehabilitation Program with tax credits. Upon completion of the project, a two-bedroom unit rented for about $600 per month. This rent level was approved by HUD to cover operating costs and to service the debt incurred in acquiring and rehabilitating the project. The rent also met HUD's fair market rent guidelines.[2] When this project was placed in service, the Denver rental market was very weak, with an 11- to 14- percent vacancy rate, and 2-bedroom apartments on the open market rented for about $450 per month, or $150 less than at the Sierra Vista project. Given the market conditions in Denver, use of existing suitable, vacant housing with Section 8 certificates or vouchers would have been the preferred means of assisting low-income families. We believe these programs would have been preferable because significantly more subsidized units could have been provided with the federal funds expended.

Using what we believe to be conservative assumptions, we estimated the total federal subsidy for this project to be about $23 million over the 15-year duration of the subsidy. This $23 million is made up of $5 million in tax credits and $18 million in rental subsidies over the 15-year period. Attachment II shows our calculation of federal expenditures per unit for the Sierra Vista project. The federal subsidy for this project equates to a present value per unit of about $58,000 in comparison to a $36,000 per unit federal subsidy for private rental housing in the same market. Expending the same amount of funds but relying on the existing housing supply in Denver and using Section 8 certificates and vouchers, the government could have subsidized 128 additional units. This figure represents about 60 percent more units than were actually subsidized in the Sierra Vista project.

---

[2] HUD allows rents of up to 20 percent above the area's fair market rent for moderate rehabilitation projects. The fair market rent in Denver at the time Sierra Vista was placed in service was $502 for a 2-bedroom unit.

OBSERVATIONS ON TAX CREDIT LEGISLATION

As you know, low-income housing tax credits are set to expire at the end of this calendar year. There are currently several bills pending that would extend the tax credit authority. Although some of the problems we reported in our August testimony would tend to be self correcting as states gain experience in tax credit allocation and as increasing competition for available tax credits permits states to be more selective in their allocation of credits, we believe it may be appropriate to amend the law as well as extend it. S. 980, now before the Finance Committee, would address many of the issues we have identified. The most important features of the bill are highlighted below.

You may recall that we recommended in our earlier testimony that a central authority be designated to review the tax credits as one part of a total financing package for low-income housing. S. 980 gives responsibility for coordinating and overseeing the tax credit program to the state housing credit agencies. It directs those agencies to develop formal plans for allocating their available tax credits among competing qualified projects. The bill specifies general criteria for the preliminary screening of tax credit applications and gives priority in the final selection to projects (1) serving tenants with the lowest incomes, (2) serving tenants over the longest period, and (3) producing the most units for the least tax expenditure.

An advantage of this last selection factor is that it encourages states to carefully review developer costs and to allocate tax credits to projects that are most cost-efficient. However, this factor may need further clarification because it could override the other two selection factors. To illustrate the potential conflict this might engender, we should consider the newly authorized tax credits on single-room occupancy dwellings and the stepped up basis (the amount upon which the credit is based) available to be applied to development activities in high building cost or extreme poverty areas. If maximizing the number of units were the overriding selection criterion for allocating credits, single room occupancy buildings would invariably be preferred because they provide the most units per credit dollar. However, single-room units may not meet community needs for family housing. Similarly, bonus tax credits--intended particularly to stimulate development activity in high building cost or extreme poverty areas--would almost never be made available because they produce fewer units per credit dollar, even though such development may be the state's most critical need.

Another feature of S. 980 intended to improve efficiency is the requirement that a state consider the total financing available to a particular low-income housing project. Under this provision, the state would examine other sources of state and federal funds and other tax benefits provided to specific projects. With the total financing picture in view, the state would be permitted to allocate only the amount of tax credit it determines is actually needed to ensure the financial feasibility of the particular undertaking and to ensure the long-term viability of the project as low-income housing. While the statutory selection criteria and allocation factors are mostly general, we believe that the states' motivation to get the most out of this housing finance option will probably help ensure that at least the minimum requirements are met.

The bill would also increase competition for tax credits by expanding their availability to include buildings acquired from HUD and the Farmers Home Administration. Another change would liberalize the current restrictions on credits for federally subsidized buildings. In areas where high building and operating costs and the extremely low incomes of potential tenants otherwise discourage development and rehabilitation, the bill would permit a stepped up basis (130 percent) to be applied to buildings in these areas. This would yield bonus tax credits and could attract development. The bill's final eligibility expansion would make tax credits available for the first time to single room occupancy, special needs housing projects, and small owner-occupied buildings.

In addition, the bill permits a 1-year carry forward of unused tax credits. This carry-forward provision eliminates the "use or lose" aspect of the previous legislation and encourages the more selective allocation of available credits. Nonetheless, we expect that the demand for tax credits will far exceed the credit ceiling allowable in most states. In this regard, tax credits alone cannot solve the problem of providing sufficient affordable housing for low-income families. There will still be a need to continue other housing subsidies for construction and occupancy at all levels.

Finally, with some limited exceptions relative to foreclosures, the bill would double the current 15-year commitment to keep the property available for low-income housing. This provision would improve the return on the public's heavy investment in tax credits.

To us, these provisions of S. 980 appear responsive and can address the problems and inefficiencies encountered in administering the tax credit program thus far. We believe the Congress should continue to monitor how state agencies are implementing these provisions so that these types of problems do not occur in the future. However, the bill does not address the specific problem of using tax credits to produce housing in markets that have surplus rental units. A basic purpose of tax credits is to increase the production of housing units. But, in some states, housing markets exist in which economic conditions have created a housing surplus.

As we have noted, in such markets more families could be served if they were provided with Section 8 certificates or housing vouchers to help them afford to live in the rental housing that already exists. The Congress may wish to consider restricting the use of tax credits in markets where vacancy rates in suitable housing are high.

- - - - -

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or Members of the Committee may have.

ATTACHMENT I

ATTACHMENT 1

Project Name[1]	Project Location	Number of Units	Tax Credits Awarded	Estimated Cash Proceeds to Developers
Windsong	Tulsa, Oklahoma	202	$5,369,440	$2,089,727
Sierra Pointe	Clark County, Nevada	160	5,788,360	1,821,006
Cleveland Gardens	Las Vegas, Nevada	36	896,150	253,740
Sierra Vista	Denver, Colorado	209	5,132,350	1,970,440
West Dade	Dade County, Florida	122	1,345,270	434,571
Baltimore Gardens	Las Vegas, Nevada	166	3,363,960	1,061,026
Pebble Creek	Arlington, Texas	352	5,823,300	2,102,963
Sun Garden	Tulsa, Oklahoma	207	4,930,240	1,732,906

---

[1] Source: Selected from projects reviewed by HUD's Office of Inspector General. See Inspector General report 89-TS-103-0005 dated April 26, 1989.

GAO Project Comparison in Denver Housing Market – 1987

	Moderate Rehabilitation Project (Using Tax Credits)	Section 8 Certificate/ Voucher Projects	Differences
Rent (2 Bedroom)	$600	$450	$150
Present Value of 15-year Subsidy	$57,697	$35,782	$21,915
Number of Assisted Units (15 years)	209	337	128 (60% more units)

Senator **Graham**. Thank you very much, Mr. Ols.

So that we can have on the record a basis for a full understanding of this program, could you walk us through the mechanics of a low income housing tax credit transaction, possibly using the example of Sierra Visa as you did in your opening statement?

TAX CREDIT PROGRAM

Mr. **Ols**. I think I will let Mr. Fricke do this.

When we were here in August, we had the big chart that demonstrated this issue. We sort of walked through all of the cash flows on that. I think that would be a good way to bring that in. We didn't bring the big chart this time.

Senator **Graham**. What I am particularly interested in is the set of administrative steps by relevant agencies, the actions by the developer, more the process at this point than particular numbers.

Mr. **Fricke**. Senator, I will try to walk it through with you the way it was walked through with us.

Really, I would say the cornerstone of the whole process has been the Mod Rehab Program. As explained to us, the developer has the commitment for Mod Rehab, which is section 8 project based assistance. They have in essence a guaranteed commitment of 15 years for rental income on that property. That rental allows them to go to a mortgage banker, and get the project underwritten for a mortgage.

On top of that developers have gone to States, and they have gotten tax credits. Now, this explains what both programs do in concert on a particular project.

Under the Mod Rehab Program, the rent ceiling that is established is 20 percent above the fair market rent for a particular area. Virtually every project we looked at, that became the rule rather than the ceiling. Developers did get rent levels at about 20 percent above the area's fair market rent.

Senator **Graham**. I want to come back and talk some more about the Mod Rehab aspect of this. I would like to start from the point that the developer is considering whether to make an application for the tax credits, what will be the factors taken into account as to whether to pursue that, and then what initiatory steps the developer takes on how those would be responded to by the administering agency.

Mr. **Fricke**. Again, our understanding would be that the developer would approach the State with an application, with a proposal.

Senator **Graham**. Each State has a designated agency responsible for making this allocation, is that correct?

Mr. **Fricke**. Yes, sir, they do.

Senator **Graham**. On what basis is the nationwide pool of tax credits allocated among States?

Mr. **Fricke**. $1.25 per capita in the State. That becomes the allocation that each State would have.

Senator **Graham**. A State that had one million people would get $1,250,000 in tax credits?

Mr. **Fricke**. Right.

Now, the developer again would approach the State with an application for a particular project. In the first couple of years the

State allocations were not used up. As we understand, today there is much fiercer competition than there was originally. So with most of the projects that we looked at the application was approved and it was approved in its entirety. There are a couple of projects where the tax credits in the State had reached a level where the developer did not get the entire allocation he would have been entitled to under the rules of the tax credit, but the majority of the projects they did get their entire tax credit allocations.

Now, to understand how the tax credit allocation would work, the developer, after putting the project together, in essence is selling—through a syndicator—the ownership interest in the property. The property is sold for the tax credit benefit to the investor. The developer will get at the time of closing a certain amount of money, proceeds from thoses sales. We understand that they also then get subsequent—usually in 2 to 3 years—the full proceeds of the tax credit.

Senator **Graham**. Excuse me. Before we go to that stage, the developer has now applied to the State agency?

Mr. **Fricke**. Exactly.

Senator **Graham**. Assuming that there are more applicants than there are funds available, what are the current criteria that the State agencies use in allocating their tax credits?

Mr. **Fricke**. Frankly, sir, that is something we didn't get into. I don't know what the States are using today or, honestly, what they did use back at the time that these projects were approved.

As I said, back at the time these particular projects were approved, the States for the most part did not have the applications commensurate with the allocation of credits. So really the projects did receive pretty much everything that they applied for in the way of tax credits.

Senator **Graham**. What commitment does the developer have to make in order to qualify for the credits?

Mr. **Fricke**. They have a period of 15 years in the current legislation.

Senator **Graham**. If, as was the case of Sierra Vista, there were multiple units, in this case 209 units, does the developer have to come in with all 209 or can he use a portion of the project—can that be committed?

Mr. **Fricke**. A portion can be committed. In these cases all units were committed, and the full amount of the tax credit was awarded commensurate with that. If less than the full amount were committed, then they would not get the full amount of tax credit.

Senator **Graham**. The tax credit goes to the number of units that are to be committed?

Mr. **Fricke**. Yes, Senator.

Senator **Graham**. When you say the developer commits to low income housing, what does that mean? How does the developer assure that that commitment would be carried out?

Mr. **Fricke**. It would be a management decision. Some group would manage the property, and they are required by the provisions of the tax credit to have those units occupied by people of a certain income in a particular market area where the project is located. If the person would move out that unit should be filled again with a person of that same or similar income.

Senator **Graham**. In most communities where there is a shortage of housing for low income families there is a waiting list with the public housing authority or some other similar agency.

Are the developers that utilize the low income tax credit obligated to take people who are on that waiting list and, if so, in any particular priority?

Mr. **Fricke**. To my knowledge, Senator, they are not. I am not totally familiar with that, but I don't really believe that they are. I think the requirement is one of income, and those who would meet the particular low income criteria would be eligible under the provisions of the Tax Code.

Mr. **Ols**. If that unit is not kept for that period of time, then that developer or manager of that particular project is subject to recapture provisions to bring money back for the credits he got, if he decides in 10 years or 5 years not to keep it available. So there are some oversights in that regard that sort of hold them into that particular length of time.

Senator **Graham**. I am concerned that—let's say in the city of Denver—that may be a bad example because the fact is you have it relative to the housing market that existed there, but a typical city, you might have several thousand people on a waiting list at the public housing authority. Should there be any relationship to that process and then the availability of low-income units that have resulted from the availability of these tax credits?

Mr. **Ols**. I don't think we have done anything to make that correlation. Maybe that would be something that we could look into as we analyze the whole process.

Senator **Graham**. And I assume that the legislation, S. 890, does not require any such nexus between applicants through the Public Housing Authority and admissions into a low income tax assisted housing project?

Mr. **Ols**. No, it does not, not specifically.

Senator **Graham**. If those who are going to appear on panel 2 are here, I would like to alert them that that is an issue that I would like to discuss with them as well as discussing it with you, Mr. Ols.

All right. So the developer has now received his credit.

Could you proceed through how the developer utilizes that grant of a tax credit?

UTILIZATION OF TAX CREDITS

Mr. **Fricke**. What we did was try to show what the source of the funds were. One would be the sale of the tax credit, the ownership interest in the property. It is the tax credit proceeds that would accure to them. That is one source of the funds to the developer.

The other is the mortgage loan that they will get on a particular project, and again that mortgage loan, being secured oftentimes by HUD insured mortgages and the Mod Rehab Program which is guaranteed rental income for 15 years.

Those two are the principal sources that the developer has for funds for a project.

On top of that there is some equity. We had wide ranges in terms of the equity that the developers were actually putting in, but pretty much the key was the mortgage loan and tax credit proceeds. The development of the property, the acquisition of the property, a developer's fee on the project, and of course when we were all done the application of funds were less than the sources of funds. We then estimated what would be the proceeds to the developer. Our earlier testimony shows that was quite large.

Senator **GRAHAM**. Could you describe further how the developer sells his low income tax credits? Do those credits go with the property? That is, in order to sell the tax credits, you have to sell the property itself?

Mr. **FRICKE**. They are selling ownership interest in the property generally through a syndicator. We have been told that there are some direct placement sales, but by and large projects are sold through a syndicator who puts the package together and brings investors to the developer to buy the interest in the property. What they are buying primarily is the tax credit.

Senator **GRAHAM**. You say they are buying the tax credit, but they actually—let's say developer A, the sole proprietor, has done everything up to this point. He has arranged the financing, including get an allocation of low income tax credits. He has built the project, overseen construction, and he has rented up the project. He now has a fully occupied building.

At this point, either through direct sale or through an intermediary, the project is sold to a group of investors. Now, those investors, they have title to the property. They have the responsibility for managing the property, collecting the rents, complying with the obligations of low income families to occupy all or a designated portion of the number of units, and they also are able to take advantage of the tax credits for their own tax calculation.

Mr. **FRICKE**. In essence, what they have done is they have bought an ownership interest in this particular project, but as far as the day-to-day management of that project that is truly an arm's-length transaction. The day-to-day management of the property would fall to the management agent to actually run it.

Really, what the investors have done is invested in a particular asset for a particular purpose, which was to get a tax credit, and really in terms of having any interest in the property per se—again it is not something that we have looked at, but just from the other work that we have done in these kinds of transactions, I would say that it would be very unlikely that they would have any direct interest in the day-to-day management of a project.

Mr. **GREENE**. Mr. Chairman, the best way perhaps to characterize it is the investors are actually limited partners, and the owner, the initial owner, is in effect the general partner. So there is a limited partner/general partner relationship between the owner and the new investors.

Senator **GRAHAM**. In your testimony, on page 1, you state: "Our preliminary results of ongoing work demonstrates that it is inefficient to use the Mod Rehab Program with tax credits in weak housing markets."

From our earlier hearings on how Mod Rehab rents were established and yesterday's hearing on how the level of mortgage was established through the coinsurers, it would seem to me that Mod Rehab is predicated on giving enough financial benefits directly through that program to make the project economically attractive to proceed.

Is that not correct?

Mr. **Ols**. That is basically true, and as we said in our August testimony, when you walk up to both windows—you go to two windows independently to get those benefits, and that just adds on to the excessiveness.

Senator **Graham**. Your comment is restricted to the inappropriateness of marrying these two programs in weak housing markets.

My question is why is it inappropriate in any market given the way fair rents and mortgage levels are established under the Mod Rehab Section 8 Program?

Mr. **Fricke**. One situation I guess where it might be appropriate would be in a housing market that is tight, that the fair market rents may not really reflect the true rents in that particular market area. In other words, they may be too low, and even with 20 percent add-on to that, the developers may find themselves in a situation where whatever return they are getting they don't think it is appropriate for whatever work or effort they are putting into the project.

Senator **Graham**. The low income tax credits are a function of the 1986 tax law. There were section Mod Rehab projects being built in strong markets and weak markets prior to 1986.

Is there any historical basis to believe that it necessitated this additional benefit, even in strong housing markets, in order to get housing for low income families which were subsidized with section 8 Mod Rehab? To put it another way, prior to 1986 had there been an unwillingness of developers to take advantage of the section 8 Mod Rehab in tight housing market areas?

Mr. **Ols**. I don't think we have done an analysis. Before the 1986 act you had a provision that allowed the developer who had invested in it to use a depreciation accelerated depreciation, which was their incentive to go into that type of market. Now, in 1986, when that was taken away, they retained—or put in this tax credit provision, which kept people coming in to fill that void, and I think that was the difference before the 1986 act, or one of the differences anyhow.

But I have not made that analysis, and I am not sure what that would show.

Senator **Graham**. Mr. Fricke, any further comments on the mechanics of how the system operates?

Mr. **Fricke**. The only comment again is I think if you look at the Mod Rehab Program and you realize that it is a guaranteed rental stream, it takes a lot of risk away from the developer. You know you are going to get, for example, $600 a month. You know that your operating costs are $250 per month per unit. That leaves $350 a month. And we figured—what would $350 per month buy in the way of debt service? If it is $20,000, $25,000, that is really what you have available to modernize that unit, and I think—again, we have been told a lot of these things may be working backward. They started with what it was that they were going to have and then kind of made the project work that way.

OVERSUPPLY OF HOUSING UNITS

Senator **Graham**. In your testimony you talk about the issue of the appropriateness of using these tax credits in oversupply areas where the housing market is weak and there are high vacancies.

Would not one way to approach that be through looking at the formula through which funds are distributed among the States and to include a factor relative to the level of housing need, supply or oversupply, in that particular State or in smaller subunits such as metropolitan areas within the State as opposed to a formula which gives $1.25 per capita to the most housing tight State as opposed to the State with the greatest oversupply?

Mr. **Ols**. I guess you could work the formula that way. That would be one approach, but it might be very difficult throughout the country to do that for all of the States, given the allocation that has certain restrictions. There are certain considerations that they have to make before they apply the tax credit, opening up to a wide range of things.

That is just another approach to do the same thing, but I think you do need something, whatever that mechanism is.

Senator **Graham**. For instance, in the FHA program I believe they use a statewide standard to determine what the average or median housing cost is, which then becomes a factor in determining how—what the ceiling is for FHA mortgages within that particular State.

I just make that comment to observe that we have some other housing programs which look at State-to-State differentials——

Mr. **Ols**. Yes, that is very true.

Senator **Graham** [continuing]. Of the allocation of federally available assistance.

We have been joined by Senator Pressler.

Senator, do you have an opening statement or any questions?

Senator **Pressler**. I do not, but I welcome the witnesses and I look forward to hearing and reading their testimony. Having three committees going at once, I haven't read much of it.

Senator **Graham**. Thank you, Senator.

On page 3, you talk about the fact that there were alternatives in these weak housing markets to achieve the same or greater housing for the dollars invested, a strategy of using certificates and vouchers to subsidize persons to move into already existing housing as opposed to using section 8 Mod Rehab and tax credits to build additional capacity.

We heard in testimony previously, specifically from a former housing administrator in Dade County, FL, that local housing authorities had been required to develop a housing plan, a strategy of how they would utilize available resources to maximize the goal of affordable housing for the residents of that community. A side question as to how much deference was given to those claims, but the plans were there in any event.

How could you see those plans generated at the local level being utilized as a means of giving a greater strategic direction to the use of these myriad of Federal programs?

Mr. **Ols**. It probably would give—whoever is giving out the tax allocations or the Mod Rehab units would probably provide a better overview from their perspective, and one other thing that I think that S. 980 calls for is a plan of how is the State going to use its tax credits.

So I think in suggesting that type of thing—and maybe it is there already and we don't have to create a whole new way of doing business. We just have to modify the existing plan that is being prepared. That might be, but it could very well work out.

Senator **GRAHAM**. As you continue your analysis of this, if you might add that to your list of items to pursue as a possible means of gaining some better control over this, over this particular program, but the larger issue of allocation of Federal funds for low income housing.

Mr. **OLS**. We would be glad to.

Senator **GRAHAM**. The specific example that you use, Sierra Vista, what date was that project undertaken?

Mr. **FRICKE**. 1987, Senator, it was placed in service.

Senator **GRAHAM**. On page 4 you state that this project had a fair market rental set at $600, but that the equivalent units in the open market were being rented for $450 a month, is that correct?

Mr. **GREENE**. Yes, Senator. The $600 figure refers to the contract rent that was created upon completion of this particular project. It is a rent that is established as a result of using the Mod Rehab approach.

Senator **GRAHAM**. I recognize that, and that approach was $150 above what the open market was saying the appropriate price should have been?

Mr. **OLS**. That is right.

Senator **GRAHAM**. I might say that I believe that we should discard the phrase "fair market rental" as it has been used by HUD and its various surrogates to describe the way in which section 8 rents were established. The fact is that any economic concept of fair market rental was abandoned as a means of arriving at the rental level. I would prefer to say that they operated like a regulated public utility, layering what the costs were, of what the developer would have to have to cover debt service, maintenance, et cetera, and then establishing a level of rents sufficient to cover all of those costs plus a margin of overhead profit, exactly the way you would decide how much a regulated public utility should get paid for its services.

And that is quite different than what most people understand to be fair market when—which is a rent established based on what that particular market—a willing landlord, a willing tenant, neither under duress—to rent would pay for an equivalent unit, which apparently in this case was $450.

Mr. **OLS**. I would agree with your scenario, and if you recall, when we testified in August we introduced into the record a report that we had issued last February, vouchers and certificates which used "fair market rent," and in fact showed that that is just an inadequate thing—a way to go about it. It is not current, that no one keeps up with changing economic conditions, whether up or down, which has an effect on the entire process.

Senator **GRAHAM**. And the converse strategy, which is to go out into the area that you are intending to survey and conduct an analysis of what the rents are, which is described by one of our earlier witnesses as being on a scale of 0 to 10 complexity, with 10 being a rocket scientist that goes to Mars, this was a small fraction, and a very simple process has been abandoned in order to use a convoluted process that doesn't accomplish the objective in determining what fair market rents are.

Mr. OLS. I think the lady that day from Florida at the panel with us went through the process of how detailed that is and what you come out with, and she was pretty articulate on that particular point.

Senator GRAHAM. I am sorry that we keep going back in the past. There are probably members of the audience here who do not—were not present to get the intellectual stimulation, the insight into human nature that has come from my previous hearings.

That was supposed to be a humorous comment. [Laughter.]

We have been joined by Senator Cranston. Senator Cranston, do you have an opening statement?

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. I have a very brief statement.

I want to welcome all of you to today's hearing. This is the third hearing before this committee to look at the scandal in HUD. Day after day, week after week we learn more about the sordid mismanagement over the last 8 years at HUD, that occurred during those 8 years.

Subsidized housing for the poor was ripped off for political favors. Billions of dollars were wasted. The major cause of the waste appears to be that there was inexcusable layering of assisted programs by developers without any concern from administration officials.

Nowhere is this as evident as the low income tax credits, which should be one of the very best programs. Developers indiscriminately layered one incentive on the other until they ended up making huge profits, profits at the expense of taxpayers in general and the low income housing recipients in particular.

One of these programs, such as coinsurance and rehab low income tax credits, can give communities the opportunities to attract low- and moderate-income housing development. Sometimes a combination I suppose is appropriate, but it was irresponsible for HUD or any other agency to allow private contractors to take more than was appropriate.

We have learned much more recently about the failure of HUD through those 8 years. We need to learn more surprising that went on and how to prevent its repetition as we put this sordid chapter behind us.

I am confident that Congress will pass major housing legislation during this session that will—during these 2 years that will make sweeping changes to HUD's practices and provide effective solutions to our severe lack of affordable housing.

Our goal is to get affordable housing within reach of most Americans by the year 2000. We have to start soon.

One question I want to ask of you—for the purpose of providing public subsidies to private developers is to mitigate the greater risk associated with developing low income housing. At our August 2 hearing, Mr. Turner of the Housing Corporation in San Francisco explained how the low income tax credit can be a valuable tool in attracting equity.

However, in previous testimony it was indicated that many Mod Rehab projects received more than was required to encourage private investment.

Would it be possible to impose restrictions on the rehabilitation costs, developers' fees, or developers' returns on investments in an appropirate why? Are developers required to make a minimum equity contribution to Mod Rehab projects, and does it correlate with the level of risk associated with undertaking the projects?

Can one of you answer that?

REASONABLE PROFIT MARGINS

Mr. **Fricke**. Senator Cranston, it is possible to develop guidelines on what is reasonable as a profit. I think in the prior hearing we had a figure of 5 percent, and others have set figures at 10 and 15 percent.

I think somebody has to administer it. I don't think you need hard and fast rules that say 10, 12, or 8 percent, but I do think you don't want to have it totally boundless where people can come in and get the kinds of returns that we saw generated on these projects.

I think it is a combination of some guidelines and certainly administrative oversight to really review the particular projects as they are coming online and look at the risk associated with bringing them online and trying to negotiate with the developer in the best interest of the Government. I think it is that kind of a two-pronged approach.

As far as the other question you asked, as far as whether or not equity equates, with risk, to an extent I would say it does. However, I think the real risk in these particular cases was largely mitigated by programs used. The developer really—when he ascertained the Mod Rehab Program commitment, he then really had a guarantee that his property on completion would be rented and it would be rented 100 percent with section 8 commitment for 15 years. He had a guaranteed rental income for that property.

There were no problems with coinsurance. All were coinsured, and to approach the mortgage banking community with that kind of a package, it is an awfully good looking deal to come to any mortgage banker with.

Mr. **Ols**. The gentleman who was with us in August was from California, and I remember him saying that he only looked at it for a 5-percent benefit to his company, or profit, but he also had no Federal assistance. All he used to get into the program to assist in building low-income housing was the State tax credits. That is all he saw as the only incentive he needed or his company needed to go ahead and do that.

So I think you need that oversight for someone looking at that to make sure that it is—that we spread that incentive to other ones that maybe we have to encourage a little bit more to come in.

I think he indicated that the groundswell is to come in and assist our fellow citizens to build this type of housing. I don't think we want to make it steadfast and say it can only be 10 percent, it can only be 11 percent, or whatever the figure might be, because of the rising costs in various parts of the country that might negate some people from participating in the program.

Senator CRANSTON. Thank you very much. I regret I cannot stay longer, but the committee is in very good hands with the presiding Senator, Bob Graham, and we have some fine witnesses.

So I thank you all very much.

Senator GRAHAM. Thank you, Senator.

I would to like to conclude with two or three questions, coming back, Mr. Fricke, to the mechanics of the program.

Let's assume in the case of Sierra Vista that the developer committed all 209 units to be low income family units.

Is it the developer's responsibility to assure that all of those units are filled?

Suppose at the end of the year 20 percent of the units were vacant or had been vacant for the preceding year. Would they still qualify for the tax credit even though they had not actually been occupied by families who met the criteria?

Mr. FRICKE. I believe, Senator, they have a certain period of time. I want to say 60 days. I am not really sure. Maybe some of the other witnesses this morning can clarify that point. However, he should make a good faith effort to rent these to lower income people.

Senator GRAHAM. We learned in our discussion recently relative to section 8 that the Federal Government essentially assumes the risk; that is, it pays the rent subsidy to the developer whether the unit is occupied or not, and I wondered if the same situation was true with tax credits.

Mr. OLS. That is something that we will look into and include in our final report as we wrap up both the prior testimony and this one.

Senator GRAHAM. Who is responsible for monitoring the families that are occupying these units to meet the standards and level of occupancy?

Mr. OLS. That would be in the local public housing authority, who would oversee that whole process.

Senator GRAHAM. If that is the case; that is, the PHA is responsible for monitoring, that seems to strengthen the rationale for saying that the PHA's waiting list ought to be looked to as the basis of filling these units. It hardly seems fair to have two low income families' needs when one has been on the waiting list typically for many months, if not years, and another family has just come into the community, that the new arrival should be given the same preference or maybe even greater preference and opportunity to get into publicly subsidized housing, subsidized through tax credits before the family then that has been waiting.

Mr. OLS. I would agree. I would have no problem if it is worked that way, and we have not worked the mechanics through with the public housing authority. They may very well do that, even if there isn't a requirement. We are just not sure at this point.

Senator GRAHAM. Given the fact that in most communities there was deficient demand for the supply of tax credits and therefore there was not the necessity of making allocation decisions, but as that situation changes and judgments have to be made, if there were inappropriate decisions made, tax credits that were excessive or tax credits granted to developers who were subsequently found not to be in compliance, is there the possibility of termination of future credits. Let's say 3 years into the project a finding is made that this was an inappropriate grant of tax credits. Can it be terminated?

Mr. OLS. There is no sanctions except for the recapture, I think, if you don't keep them available and use them for low income housing. I don't believe that there is any other sanctions.

Ms. ARMAN. I don't think so.

Mr. OLS. Other than recapture of the tax credits that you use at the beginning of the project, I don't believe that there is anything else that says that they were approved—for example, I don't think there is much in the way of guidelines prior to some of the proposals that are being considered now. So there is nothing really to comply with.

You want to create more low income housing. Here is the tax credits. So therefore there weren't any other caveats or covenants put on it that I know of.

Senator GRAHAM. As I understand the way the program operates, you get 10 years of tax credits calculated under this formula, which is 4 percent for acquisition and 9 percent for rehabilitation.

Mr. OLS. Right.

Senator GRAHAM. Let's just assume in a particular project that amounted to $100,000. You would get $100,000 in each of 10 years?

Mr. OLS. That is right.

Senator GRAHAM. What I am asking is let's say that we now get to year three and you have collected $100,000 for each of 3 years in the form of tax credits, and now a determination is made that either because you haven't been renting to the type of people that you said you were going to rent to or there was some misrepresentation in your original application you are terminated.

Mr. OLS. I would think—and I turn to my counsel, but I think that you would not be entitled to use the tax credits in the outyears and you might have to go back and recapture a portion of the credits you got. Let's say if you only use 50 percent of the 209. Therefore, 50 percent—I am not sure it would work out—50 percent of the tax credits have to be readded or reprovided back to the IRS as far as that is concerned. I would think that is how it would work.

Ms. ARMAN. I might say that this is a very technical provision of the Tax Code, and it would be—we would be happy to verify all of these assumptions later, at a later time.

Senator GRAHAM. Very good. If you could prepare a memorandum, a legal analysis of this section of the Tax Code as it relates to questions that have been asked this morning, I would appreciate it.

Ms. ARMAN. Regarding the capture and continuing monitoring of the use, we would be happy to.

Senator GRAHAM. The linkage between the public housing authority's eligibility list and filling units, the question of allocation to States.

This may be getting into the area of modification, but is there—you have recommendations of how the program might be amended so as to take into account the economic differences among the States in terms of their supply of housing for low income families.

Ms. ARMAN. We would be glad to do that, Mr. Chairman.

Senator GRAHAM. Thank you very much. I appreciate, as always, your very responsive and helpful testimony.

We have a vote underway. I will go make that vote and return as quickly as possible, at which time we will turn to panel 2.

Thank you.

[Recess.]

Senator GRAHAM. Ms. McFall and Mr. Roberts, I apologize for the delay. I appreciate your patience. I am somewhat apologetic in asking you to stand and be sworn, but we are doing this for all of the witnesses in this series of hearings.

Would you please raise your right hand?

[Witnesses sworn.]

Senator GRAHAM. Trudy McFall, executive director, Maryland Community Development Administration, speaking on behalf of the National Council of State Housing Agencies.

STATEMENT OF TRUDY McFALL, EXECUTIVE DIRECTOR, MARYLAND COMMUNITY DEVELOPMENT ADMINISTRATION, ANNAPOLIS, MD

Ms. McFALL. It is a great pleasure to be here. I am, as you have said, the director of the Housing Finance Agency in Maryland, and I am pleased today to represent the National Council of Housing Agencies.

We are a 58-member group dedicated to housing development and finance on a statewide basis in our States.

I think probably most pertinent to today's discussion, there are 45 of us, including my agency, who administer the low income housing tax credits.

I am always pleased to represent States in a discussion about partnerships with the Federal Government in the development of low income housing, and I am pleased to represent my own State of Maryland, which like many States has made a very strong commitment to making affordable housing possible, and certainly this is true of our member agencies as well.

Collectively, we have through our tax-exempt bond authority helped one million people buy homes and 800,000 households have rental housing. I would like to say on behalf of myself and my other State colleagues that what we bring to this discussion is our strong enthusiasm for saying to you, as you look at these issues of housing subsidies and tax credits, that we come ready and eager to bring our resources, not only our financial resources, our State funds and our tax-exempt bonding authority, but I think perhaps, even more importantly in the context we are in in the national scheme of things, our proven expertise and track records and the capability of our staffs and our various agencies who have considerable skill in underwriting, monitoring, and administering the Federal moneys. We can all agree that we need all the resources we can get to capably managing our housing programs today.

So we are very pleased to be your partners in doing that.

As the allocator of tax credits nationally, the State agencies have made 200,000 units possible through the allocation of tax credits, and so it is an enormously important program. In my own State, in 3 years—it is a relatively small State—we have done 120 projects because of low income housing tax credits. So it is a program that I come with a great deal of interest and vigor to talk to you about today.

And I have the pleasure of following Mr. Ols from GAO. I think that they echoed some of the sentiments, perhaps from an even more objective viewpoint, about our State capabilities.

I would really like to make on behalf of NCSHA three key points and talk about some of the other issues on the table. I, like the previous witness, will try to highlight my testimony because I know this is a very busy time for you. I would like to say three things.

We affirm and have already said that State agencies take very seriously the responsibilities that we would be given under the Mitchell-Danforth tax credit legislation. We suggested many of the things initially that are in that legislation. We have formulated and are very enthusiastic about it.

The NCSH helped to staff the committee, so we feel pride in the Mitchell-Danforth bill and are glad that folks like the GAO are also supportive of it.

We think the Mitchell-Danforth allocation proposals provide a real response to the kinds of issues that we are concerned about and the appropriateness of the level of subsidies in housing projects, and we think that they laid out the ideal method for determining the appropriate combination of project subsidies, including tax benefits and other State and local subsidies.

There is discretion for particular projects, and that is critical, given the complexity and variations in the projects' financing, and the flexibility to combine credit with other subsidies is also very essential because additional assistance must be present to make tax credit projects feasible.

Third, the allocation process envisioned under Mitchell-Danforth meshes well with the housing legislation being developed in this committee. The process outlined in the Mitchell-Danforth bill we think can serve as an excellent model for the planning, strategies, and selection processes governing other Federal subsidy programs over which this committee has jurisdiction.

I would like to address each of these points in just slightly more detail.

First, on the subject of allocation plans and project evaluation, as you know, we have already made clear that we played a major role in Mitchell-Danforth. The Mitchell-Danforth task force that led to it said the following on the subject of allocation:

> That to encourage the greatest use of credit to meet State housing needs, the State allocating agency should be required to devise public allocation plans and administrative guidelines governing the use of the credit and establish a process for analyzing each project to establish the amount of the credit it would receive.

This task force recommendation resulted in inclusion in the Mitchell-Danforth bill. We would be required under that bill, we the State allocating agencies, to first adopt a qualified allocation plan, and to do that we would have to assess the needs for housing in our area and to set forth a variety of selection factors by which low-income housing tax credits would be allocated.

And if I could pause here just a moment and say that the testimony of GAO about their concerns about tax credit uses in weak areas, I think we should take a careful look and see if the provisions already in Mitchell-Danforth don't speak to that. We are told under the provisions of that bill to assess our needs and to make locational decisions about the allocation of tax credits. I cannot imagine a responsible process that wouldn't, therefore, identify a weak market area and make appropriate recommendations and shifts on the tax credit allocations within the State in response to that.

I do think that we are not without an answer to that concern that they raised in the Mitchell-Danforth proposal. The public would be deeply involved in the allocation plan. The selection criteria under the law would have to have public participation, due notice for governmental approval, and then the Mitchell-Danforth proposal has what I think probably is the most important provision for the context of the present hearings you are having. That is, the need for what the bill calls an evaluation process for individual projects, and that is the provision which says that housing credit agencies must only allocate the amount which—and I am quoting—"it determines is necessary for the financial feasibility of the project and its viability as a qualified low income housing project throughout the compliance period."

So here are the requirements that tell us to look at the subsidies going into the project, whether it is tax credits or other subsidies, and underwrite the project and make decisions based on our knowledge and experience of the financial viability of the projects, and to allocate the correct and only the correct resources to the project.

We think that the concerns that Congress has raised, GAO, Treasury, the IRS, our own agencies, everyone has raised about the use of subsidies are a valid concern, and I would certainly like to stand with the GAO as saying that we think housing finance agencies, not surprisingly, are capable of helping you provide the kind of oversight and management of the process which could assure you that abuses will not occur.

The second point I would like to make, part of the question you are talking about here in this hearing is the issue a combining of Federal subsidies. I think this is really a very critical question, and I implore you, while taking a valid examination of the issue of how section 8 Mod Rehab has been used in the past, not to conclude that there is anything inherently evil in there being tax credits and Federal subsidies in the program.

I want to say to you as strongly as I possibly can, that my experience and the experience of virtually all of my colleagues is that the projects which do not need other forms of subsidies in combination with tax credits are very rare. There are some areas in the country that have that happy combination of high median income and low construction costs, and we would have a few of them in spots in Maryland where you can make tax credit projects be basically stand-alone and the tax credit provides sufficient subsidy. But in the overwhelming number of cases it takes tax credits and some other form of subsidy used in combination to make a viable project.

These are projects that have 10 years of tax breaks and 15 years of low income compliance, heavy targeting, and it simply takes a variety of subsidies.

What I would say to you, sir, is that it is not the issue of the number of subsidy programs that go into a project. It is the issue of the total amount of the subsidy, and if we have been negligent in the past of not looking at these as packages in some places or some projects, we should correct that through Mitchell-Danforth. We should not overreact to this.

In Maryland we have many State subsidy programs, and we deliberately use them in combination because we want to use certain programs to accomplish certain parts of the things that the project is doing.

So please don't take this double dipping or combination of Federal subsidies to think that that is the bad parts of it. The bad part is that we need to look at the total package, what Mitchell-Danforth provides for, and we certainly should—as part of the process of looking at how much tax credits goes into the process, we certainly agree that we should look at all of the costs of the project—soft costs, hard costs, personnel services, all of those things that are included in the development process.

We think that is a very important part, and we endorse the comments that Mr. Ols from GAO made, that we think that it is reasonable to ask us as allocating agencies to have guidelines and some framework for what the reasonable rate of costs are. We do not think that standards, requirements are desirable. We need the flexibility.

We said to you as State allocating agencies in the context of Mitchell-Danforth that we should take on more responsibilities. We are willing to, but we also need flexibility in return for being able to provide the amount of subsidies and allow development fees adequate to cover the individual situations and risk elements of individual projects.

Would you like me to comment on your public housing, question or would you just prefer to ask me that question?

Senator GRAHAM. I am going to ask that question. If you would like to comment on it now or after Mr. Roberts has made his statement?

Ms. MCFALL. Let me comment on it, and then I will close because I have given you an abbreviated version here.

First of all, I just hope that we are clear. I think that there may have been some confusion that public housing authorities now have a monitoring role. GAO's answer was close to correct because they were speaking of mod rehab projects and public housing authorities would have monitoring roles under the section 8 subsidy, but they wouldn't have a monitoring role of the tax credit compliance, nor do the allocating agencies. That is between the IRS and the owners and investors in the project.

I say that only because I think it would be incorrect to conclude now that there is a natural fit between any ongoing monitoring role of the public housing authorities or allocating agencies and your issue on the waiting list.

Having said that—and our organization obviously has not had a chance to talk about this—I don't think it is unreasonable when a project is developed in a jurisdiction that has a public housing authority with a waiting list to require the developer to notify the housing authority about this new housing that is coming into the housing supply. We think that is a very good linkage between—as you say, between people who have waited a long time for housing and some new housing becoming available.

I think we have to be realistic, that many people on the housing authority waiting list may not be able to qualify for tax credit projects because unless they do have other subsidies and typically, maybe in general, they might be below the incomes, that can be served in a tax credit project, but nonetheless I think that is a fine idea.

With that, I really have wrapped up my comments, and I think I have made my points that we are enthusiastic and eager, and we think that Mitchell-Danforth is a great corrective piece of legislation, and we look forward to being enthusiastic and credible implementors of it.

[The complete prepared statement of Trudy P. McFall follows:]

Testimony of Trudy P. McFall, Executive Director, Maryland Community Development Administration On Behalf of the National Council of State Housing Agencies Before the Senate Committee on Banking, Housing and Urban Affairs

September 29, 1989

Mr. Chairman and Members of the Committee, my name is Trudy McFall and I am here representing the National Council of State Housing Agencies (NCSHA). I am the Executive Director of the Maryland Community Development Administration, the Low-Income Housing Tax Credit Allocating Agency in Maryland.

NCSHA is a national, not-for-profit organization created in 1970 to assist its members in advancing the interests of low and moderate income persons through the financing, development and preservation of affordable housing. NCSHA's members are housing and finance agencies with statewide authority. Today, NCSHA's 58 member agencies are operating in each state, as well as the District of Columbia, Puerto Rico and the Virgin Islands.

Through tax-exempt bonds, state housing finance agencies have helped more than one million Americans afford to buy their first home. We have also financed over 800,000 units of low and moderate income rental housing, including more than 200,000 units since 1986 using the Low-Income Housing Tax Credit (the credit). Our agencies now allocate the credit in 45 states.

Mr. Chairman, I appreciate this opportunity to appear before this Committee to comment on the use of the Low-Income Housing Tax Credit with other federal subsidies. I want to make three major points this morning:

1. State housing agencies take very seriously the responsibilities asked of us under the Mitchell-Danforth tax credit legislation. We initially suggested, helped formulate and enthusiastically supported provisions which require state credit allocation plans and project-specific evaluations.

2. The Mitchell-Danforth allocation proposals provide the best method for determining the appropriate combination of project subsidies, including tax benefits and other federal, state and local subsidies. State discretion to determine the amount of tax credit needed in a particular project is critical given the complexity of, and variations in, project financing. The flexibility to combine the credit with other subsidies is also essential as such additional assistance must be present in all but exceptional circumstances to make credit projects feasible.

3. The allocation process envisioned under the Mitchell-Danforth bill meshes well with the thrust of the housing legislation being developed in this Committee. The process contained in the Mitchell-Danforth bill can serve as a model for selection processes governing other federal subsidy programs over which this Committee has jurisdiction.

State Allocation Plans and Project Evaluations

Mr. Chairman, as you may know, NCSHA played a major part in the process that led to the issuance of the Mitchell-Danforth Task Force Report on the Low-Income Housing Tax Credit. Two state housing agency directors, Elizabeth Mitchell, Director of the Maine State Housing Authority and Terry Duvernay, Executive Director of the Michigan State Development Authority, served on the Task Force which was commissioned by Senators Mitchell (D-ME) and Danforth (R-MO) to review the credit's performance and propose program modifications. Elizabeth Mitchell chaired the group. NCSHA provided staff and logistical support to Task Force members and was responsible for providing drafts for members' review.

The Task Force -- long before the attention of Congress was drawn to revelations in the awarding of HUD funds -- recognized that demand for the credit would exceed supply and was very clear on the role that the state allocating agencies should play in this new era.

As the Task Force report states:

> To encourage the greatest use of the Credit to meet state housing needs, the State allocating agency should be required to devise public allocation plans and administrative guidelines governing the use of the Credit and establish a process for analyzing each project to establish the amount of the Credit it would receive.

This recommendation, advanced by the Task Force with state agency support, resulted in the provisions contained in the Mitchell-Danforth bill, S. 980. That bill has been co-sponsored by seventy-one Senators including fourteen members of this Committee.

Under Section 2(o) of S. 980, credit allocating agencies must first adopt a "qualified allocation plan." A qualified allocation plan must set forth selection criteria which reflect the state's housing priorities and give preference to projects serving the lowest income tenants and projects obligated to serve low-income tenants for the longest periods. Allocation plans must address a number of factors such as project location, housing needs characteristics, project characteristics, sponsor characteristics and tenant populations with special housing needs.

The public will be deeply involved in the process of creating allocation plans. The bill requires approval by the appropriate government unit after a public hearing which follows reasonable notice. Mr. Chairman, we see this as a critical element; encouraging public participation not only makes good sense but also is important in building public support for housing programs and confidence in this process.

The bill also requires an evaluation process for particular projects. The housing credit agency must only allocate an amount which it "determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the compliance period . . . " In conducting an evaluation, the allocating agency must consider the sources and uses of funds, the total financing plan for the project and any proceeds expected to be generated by reason of tax benefits. In addition, the applicant for the credit must certify to the housing credit agency the full extent of all federal, state and local subsidies which apply or are expected to apply to the project under consideration.

Mr. Chairman, we believe that the project-specific evaluation process will allow us to make reasoned decisions as to how much tax credit will be needed in light of the total financing picture with respect to that project. Making this a public and open process and requiring agencies to look very closely at all the elements that must be present to make a particular low-income project viable is the best possible way to make sure that scarce resources are allocated in a manner which best serves the public's need for this housing.

We share the concerns that this Committee and others have had with respect to how federal housing dollars have been spent and how decisions have been made over the past several years. We are aware that the Congress and the General Accounting Office, the Treasury Department, the Internal Revenue Service, the press and the public will scrutinize what we do very closely. We are confident that the state housing agencies are well equipped to conduct this process, as set forth in the Mitchell-Danforth legislation, in a competent and responsible manner.

Combining Federal Subsidies

Another proposal contained in the Mitchell-Danforth legislation addresses what we understand is a major concern of this Committee. This proposal changes present law on the impact of federal subsidies on the amount of tax credit available. Under present law, if a project is classified as "federally subsidized," it is limited to a 30 percent present value (approximately 4 percent annual) tax credit. The bill would change the definition of "federally subsidized." We believe that added flexibility in this area is necessary.

Mr. Chairman, my experience and that of virtually all of my colleagues is that projects which do not need other forms of subsidies are a rarity. There are some areas of the country where the combination of high median incomes (which determine rent levels) and low costs of construction will allow for "stand-alone projects" to be developed. However, our statistics and our experience indicate that these are rather exceptional circumstances. Indeed, last year over 80 percent of credit projects were developed utilizing other forms of subsidies.

Furthermore, we need flexibility because the development, rehabilitation and preservation of low-income housing is a tremendously complex process. Local or regional conditions will in many instances dictate what will be necessary to make a project feasible. There are very few "cookie cutters" in this business. The era of "one-stop shopping" -- where all the financing and the subsidies could be obtained from HUD is clearly over. Today, in order to get a low-income housing project off the ground it may be necessary to combine several sources of financing, rental subsidies, below-market loans, grants and private equity capital, in a creative endeavor which is fraught with risks for all involved. There is simply no way that anyone can predict with any certainty on a national basis how much credit or how much subsidy might be needed in any given situation. There are just too many variables.

We recognize, of course, that broad limits are necessary and we are not advocating a wholesale change in the present law limiting the amount of tax credit that can be awarded. And although we would like more tax credit authority, we are cognizant of budget constraints. It boils down to how states decide to divide the pie. We do not intend to award overly generous slices because that will only deprive us needed low-income housing.

The increased discretion to provide additional tax credits even where a project is "federally subsidized" is a reasonable and necessary part of the increased state agency role in evaluating project needs. We intend to look very, very closely at the total subsidy package in evaluating projects.

I think it is important to underscore the critical role that the tax credit plays in the overall financing of low-income housing so that an assessment can be made as to how other subsidies should be combined with it. The tax credit generates an infusion of private equity capital, generally in the form of capital contributions by investors through partnerships which own low-income housing projects. That equity capital often fills the gap between the total needs ("uses") and total resources ("sources") in the financing package. The Mitchell-Danforth bill requires us to review "sources and uses." Private capital contributed by individuals and corporations decreases the need for other types of governmental assistance. I might add that the flow of private capital into low-income housing gives the public a real stake in the administration of the program.

The capital generated by the tax credit goes into the "sources" side of the equation and is combined with other "sources" to make up the total financing package. We will be looking very closely at the "uses" side of the equation to make sure that costs are reasonable. We will look at hard-costs and the cost of personal and professional services that are rendered in the development process. We all must understand that there is a long, difficult and very risky development process which must be undertaken by private sector companies. These companies may be either for-profit or non-profit entities. States will have to determine what is reasonable and justified under the circumstances. Once again, each credit allocation will call for the exercise of sound and reasoned discretion, but we believe that the process established in the legislation will provide for sound, publicly oriented decision-making.

As a final point, the credit program actually provides an incentive to keep total costs down. Under the credit program, costs cannot exceed what can be supported by rents. Rents are tightly restricted under the rent restriction test set out in the Code (30 percent of qualifying income with certain adjustments). I believe that the combination of our scrutiny and the built-in protections contained as a result of the rent restriction test will help us in determining the reasonableness of project costs and in assessing how much credit (or other subsidies for that matter) will be necessary.

The Credit Allocation Process As A Model

As I noted earlier in my summary, the credit allocation process meshes well with the thrust of the housing legislation being developed in this Committee. NCSHA has had several opportunities to testify before this Committee on the National Affordable Housing Act and enthusiastically supports its elements that result in greater state and local decision-making. The credit allocating agencies expect to be working very closely with federal agencies like HUD and the Farmers Home Administration in utilizing funds that may be made available under this housing legislation. We recognize the importance of efficiently combining and leveraging federal resources and other forms of assistance.

NCSHA has recommended that the Mitchell-Danforth allocation and project evaluation processes outlined above serve as a model for other funding programs which this Committee oversees.

Mr. Chairman, let me stress again how seriously we take this process and how much we welcome it. My colleagues and I at the state housing agencies are dedicated to housing lower-income Americans, and we fully intend to allocate the credit so as to provide as much public benefit as possible in a manner which is open, fair and reasonable to all the parties concerned.

Mr. Chairman, that concludes my testimony, and I will be happy to respond to any questions the Committee may have.

Senator **Graham**. Ms. McFall, I can tell you that you are a very enthusiastic, committed person. I had the opportunity to be very familiar with a State agency, a member of your association, while I was Governor of Florida, and we are very proud of the contribution that our agency made, and I am certain that that is true of yours in Maryland and the other members of the national association.

I very much appreciate—and I was not, frankly, aware of before your testimony—your deep involvement in shaping the amendments which will soon be considered to the low income family housing tax credit.

Mr. Benson F. Roberts, special assistant for policy and program development, Local Initiatives Support Corp., Washington, DC.

STATEMENT OF BENSON F. ROBERTS, SPECIAL ASSISTANT FOR POLICY AND PROGRAM DEVELOPMENT, LOCAL INITIATIVES SUPPORT CORP., WASHINGTON, DC

Mr. **Roberts**. Good afternoon, Senator Graham. It is a pleasure to be here.

I am from the Local Initiatives Support Corp. We are a national organization. We are nonprofit. We exist to work with low income community-based nonprofit organizations to help them revitalize distressed low-income neighborhoods. We do this through 25 programs around the country, one of which is in greater Miami. We work there with the Tacolcy Economic Development Corp., the East Little Havana CDC and several of the other grass roots community groups.

We have been very involved in attracting private resources to nonprofit community-based development. Since we were started 10 years ago by the Ford Foundation with capitalization from Ford and six corporations of $10 million, we have gone on to attract another $300 million from the private sector. About one-half of that has come from corporations in the form of investments based on the low-income housing tax credit. We have been able to attract those corporations on the basis of being able to do well by doing good. All of these funds then funnel down through the community groups into low income neighborhoods, and it has been a very gratifying experience, I think, for us all to see the response to this approach.

We work very closely with public agencies at the State level and the local level as well to make these projects work because we know that unless we have those partnerships in place we cannot do very much.

I would like to talk a little bit about the combination of different housing subsidies within a single project and, if I may, to walk you through our process as we go about packaging the financing for low income housing projects, particularly in a low-income neighborhood.

The first question is: does the project really need more than one subsidy? And I would agree with Trudy that in the vast majority of cases the answer is yes, and the reason is very simple math.

The cost of developing a project is greater than the rents affordable to low income people can support, and no single program provides a deep enough subsidy to fill the gap. The financing structure depends on where the project is located, how much rehabilitation is going into the project, and what rents low income people can afford in that neighborhood, but in general we see the stitching together of a whole patchwork of subsidies from States, localities, foundations, the business community, religious institutions, and organizations such as ours, and it is all needed. We wish it weren't all needed sometimes, but it is. That is the reality of it.

A positive part of this situation is that partnerships have been brought together and the tax credit has played a very important role in that. Whan we are able to go to a city like New York and say we can attract $25 million from corporations for low income housing in the city of New York, the city of New York has responded extremely positively by offering their own resources and buildings to make this work through grass roots community groups. It has not been any easy process, but it has been, I think, a very positive one from the standpoint of involving all sectors of our society in addressing these problems.

As you know, Senator, there are really three tools that one has to employ to finance low-income housing. One is equity, the owner's investment. The second is private bank mortgage financing. And the third is usually that gap that the public sector has to come in with in the form of either grants or very, very low-interest loans to make the financing work. They really are very different tools for different purposes.

In terms of equity, you want to have owners with a stake in the project. You don't want to have so much debt on the project that it really has no bearing to the reality of the value of that housing. Equity investors do not invest in low-income housing on the basis of economics. So tax benefits are what you have to provide, and this is not new. In fact, tax benefits have been used by Federal policy to attract equity investment to low income housing since the 1960's. Even prior to 1986 there were tax benefits available to investors. It is simply that the credit is the latest of these, and it is the most rigorously targeted to reach low income people. In that regard the credit is a substantial improvement from a policy point of view.

Then there is market rate financing. This is really just a function of what the rents are and what the operating expenses of the project are. You have got to carry that mortgage, and in many cases those rents are very low, and so therefore the mortgage that can be carried is very limited. This is where the Mod Rehab Program comes in because it ensures a rent that is in fact higher than market, and that allows you to carry a larger first mortgage. That changes the nature of the financing package so that you have depending on the project, either a smaller gap left for public subsidies to fill or in some cases even a surplus of benefits to the project sponsor. It really depends on the specifics of that project. I will get to that in a moment.

The real issue then I think is really not whether subsidies can or should be combined, but rather whether they are sufficient or too generous for what the project needs.

Our typical project would involve, say, the gut rehabilitation or new construction of a building in a low income neighborhood where the market is weak. When we talk about weak markets, you know, low income neighborhoods often have weak markets, and I hope you would not say that therefore they shouldn't get any housing subsidies. I would say that in fact these are precisely the markets that we need to stabilize through new investment, and that does require Federal support.

So with that little digression, that is really typical of the kind of project that we work on, and typically we don't get Mod Rehab subsidies in our projects. The project has to work within the market dynamics of, for example, Liberty City. In those kinds of places we can go and raise equity from investors and we can go out and get some market rate financing, in the case of Miami through a new consortium of banks called Homes for South Florida, which is doing a terrific job of channeling funds into low-income housing from the financial institutions. But still there is a big gap between how much debt you can carry and how much equity you can invest. If you had Mod Rehab in the mix, that would help a lot.

But again, if you are going to do gut rehab, you are still going to have something of a subsidy gap because, as I say, you can carry a bigger mortgage but not a sufficiently bigger mortgage to make the project work without gap financing. I have attached to my testimony some case studies that lay out the variations in these financing packages.

Now, the projects that GAO has brought before us today, and also last month, did have the Mod Rehab subsidy and the tax credit, but did not involve gut rehab. They did involve a moderate degree of rehab, say $15,000 to $20,000, and because they involved less rehabilitation they got less of a tax credit. But still the total cost of that low-income housing was so much less that the project sponsors came out with a surplus, and I don't think any one of us here is suggesting that that is appropriate.

But I think those are the specific kinds of projects where that happens, and I think it is important to keep that perspective in mind. Even if you look at all of the tax credit projects and look at how many of them involved Mod Rehab subsidies, it is a small minority. Someone who is familiar with some of the data suggested to me earlier that it might be about 15 or 10 percent of the tax credit projects. So this is not the standard way tax credit deals happen, and I would suspect that many of the mod rehab projects actually involved substantial rehabilitation, so that the Mod Rehab subsidies may have been necessary and not inappropriate or excessive.

So I think it is just extremely important to underscore the point that Trudy made that it would be a mistake, a bad policy mistake, to infer from the cases that GAO has brought before us that these subsidies should never be combined.

Now, the second question, what do you do about it? Trudy has done a very good job of presenting the Mitchell-Danforth proposal. We, too, had a hand in working on that task force. Paul Grogan, the president of LISC, was a member of the task force, we are part of the group recommending that these new requirements be put into the law, we support them fully, and we think that they are appropriate and necessary in order to make sure that the Federal Government gets the most for its money.

That concludes my testimony, and I would be delighted to answer any questions.

[The complete statement of Benson F. Roberts follows:]

STATEMENT OF

BENSON F. ROBERTS

LOCAL INITIATIVES SUPPORT CORPORATION

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

U.S. SENATE

ON

THE USE OF LOW-INCOME HOUSING TAX CREDITS WITH SECTION 8 MODERATE REHABILITATION SUBSIDIES

SEPTEMBER 29, 1989

STATEMENT OF BENSON F. ROBERTS

Good morning, Mr. Chairman. My name is Benson Roberts. I am Special Assistant for Policy and Program Development at the Local Initiatives Support Corporation (LISC).

Background on LISC

LISC is a national, nonprofit organization that provides financing and technical assistance to nonprofit community development corporations (CDCs). LISC was created by the Ford Foundation almost ten years ago to attract private sector financial and technical resources for the rejuvenation of deteriorated communities and neighborhoods. LISC is the largest private, nonprofit community development organization in the nation. We have raised over $200 million from more than 500 private corporations and foundations. Of this amount, $65 million has come from major corporations as equity investments based on the Low Income Housing Tax Credit. This is an extraordinary testament to the power of the CDC model to attract broad support from all segments of the community.

LISC does not develop projects itself. Instead, we invest these resources in housing and commercial development programs carried out by CDCs. About 550 CDCs now have received program support from LISC. This help has led to the production of 17,000 low- and moderate-income housing units, as well as 5 million square feet of retail, office and industrial space. LISC support has leveraged additional investments of $1 billion from local banks and other private and public partners. This activity has occurred entirely in distressed low-income neighborhoods, entirely under CDC sponsorship, and almost entirely since federal funding for housing and community development was severely curtailed starting in 1981.

LISC's loans and grants are made with the expectation that CDCs will undertake projects as part of a focused, long-term community development program. To this end, LISC operates through a nationwide network of 25 local, regional and statewide "areas of concentration." Each area draws on local corporations and foundations for funding and continuing guidance, and receives matching support from LISC's national resources.

LISC also helps to create -- and in some cases implements -- citywide and national programs that facilitate CDCs' access to financial and technical resources and build their capacity to produce housing on a greater scale. LISC and its affiliates are:

- Raising equity investments from corporations based on the Credit.
- Operating a secondary market for socially motivated lenders.
- Conducting citywide programs in several localities to build CDC capacity and produce low-income rental housing and ownership housing on a substantial scale.

Our perspective on federal housing programs therefore, is as a dedicated, experienced, and -- we believe -- effective catalyst for low-income housing and neighborhood revitalization in communities nationwide. As a public purpose organization, we want to ensure that scarce federal resources are being used effectively and efficiently to benefit low-income people and communities.

The Emergence of CDCs

CDCs are nonprofit organizations, are accountable to the communities in which they operate, and are development corporations. According to recent research by the National Congress for Community Development, 1,500 to 2,000 CDCs are now operating that have completed at least one development project. Rehabilitation and construction of low-income housing are the primary activity of most CDCs. The 631 CDCs responding to NCCED's survey report the production of 125,000 housing units. CDCs also develop commercial and industrial facilities, provide social services, such as job placement, and advocate on behalf of their constituents. The ultimate mission for many CDCs is to reduce poverty, stabilize distressed or declining neighborhoods, and gain economic power for their communities. Housing low- and moderate-income people is thus not just an end in its own right, but also a tool for achieving this broader mission.

The active involvement of CDCs is not a new phenomenon, but only recently have CDCs become widespread housing producers. The first CDCs drew attention in the late 1960s and early 1970s as attractive development vehicles because of their commitment and sensitivity to community needs in selecting, structuring and implementing projects. In very real terms, CDCs have enabled low-income community residents to take direct control over whether and how development takes place in their neighborhoods. Absent CDC involvement, many low-income neighborhoods saw no development activity at all. CDCs have enabled low-income community residents to define the scope, design, and location of proposed ventures, as well as to participate in the political process through which many development decisions are made.

Federal funding cutbacks in the 1980s have focused more attention on CDCs, and their role in producing low-income housing has grown more prominent. Part of this prominence is attributable to the withdrawal of profit-motivated developers as federal programs were cut back; indeed, CDCs are in many cities the only housing developers still working in low-income neighborhoods. But CDCs have not simply been good survivors of federal subsidy cutbacks; their number and sophistication have actually multiplied in the 1980s.

At least four factors explain this phenomenon.

- First, many communities realized they could no longer depend on profit-motivated developers to produce low-income housing, and with housing needs rising, have decided to take on the responsibility for developing housing themselves.

- Second, the ability of CDCs to work collaboratively with a wide range of public and private sector institutions has grown dramatically. CDCs have been earning their place at the negotiating table with mayors, bankers, and profit-motivated developers by contributing tenacity, a respected voice for their neighborhoods, and growing technical sophistication. These are very important ingredients in rebuilding communities.

- Third, as CDCs and have become more widespread and successful, they have become far more visible. So as churches, social service agencies, neighborhood activists, city and state governments, local foundations, and others committed to providing housing have searched for new solutions, the CDC model has been much easier to identify, and has been perceived more often as effective.

- Fourth, the technical and financial support available to CDCs has grown substantially over the past several years, enabling more CDCs to get started and undertake more complex projects. The advent of nonprofit "intermediaries," such as LISC, the Enterprise Foundation, and the Neighborhood Reinvestment Corporation, has also helped to expand CDC resources.

The interest CDCs have sparked arises not solely from their increasing number and skills in a period of federal retrenchment. Indeed, a wide range of policy makers in both the public and private sectors are deciding that CDCs are worth encouraging because of the unique combination of resources they bring to low-income housing and community development.

- Their knowledge of community housing needs, markets, and opportunities and their ability to undertake flexible and effective programs that respond to these circumstances.

- Their commitment to serving low-income households on a long-term basis. This commitment is becoming increasingly attractive to policy makers as existing HUD-assisted low-income housing projects become threatened with defaults and conversions to upper-income use.

- Their ability to produce housing within the context of an overall neighborhood preservation strategy. The Section 8 new construction and substantial rehabilitation programs were operated with little regard for their impact on housing in the surrounding community. Yet, most existing low-income housing is unsubsidized and tends to be concentrated within distressed communities. If we care about the overall supply of low-income housing, then we must concentrate on stabilizing the distressed low-income communities where so much of this housing is located. The inherent scarcity of public subsidizes also compels us to use these funds strategically. That is exactly how CDCs work. CDCs use new investments in housing to bolster their neighborhoods and the existing housing in them.

- Their willingness to undertake projects that profit-motivated developers consider too small, too risky, insufficiently profitable, and located in neighborhoods that are too distressed.

- Their political and technical skills in assembling multiple public, private, and charitable resources to make projects feasible and in marshalling community support.

Those of us who have witnessed first hand what CDCs have been able to achieve in such hard times believe they can succeed in every low-income community in America, if they are given the chance.

Combining Housing Subsidies

The issue before us today is whether it is necessary and appropriate to combine multiple sources of public subsidies within a project, and if so, how public oversight can be exercised to ensure that these subsidies are not excessive.

First, does one project really need more than one subsidy? In most cases where the objective to build new housing or substantially rehabilitate deteriorated housing, the answer is "yes".

The reason is simple math. In almost every case, the cost of developing a project is greater than rents affordable to low-income tenants can support. And no single program provides a deep enough subsidy to make a project feasible. Many projects must stitch together a patchwork of direct and indirect subsidies from federal, state, and local government, religious institutions, foundations, the business community, and organizations like LISC. One of the most positive trends of the 1980s has been the increasing willingness of these partners to participate in low-income housing and community development. The Credit has played an important part in this process. It has given corporations an investment that allows them to do well by doing good. And their participation has reduced the need for other subsidies to a more manageable level and encouraged other partners to become involved.

There are three basic sources of permanent financing for low-income rental housing: equity, market-rate first mortgage financing, and public subsidy or gap financing.

- Equity investment depends mostly on development costs. These costs determine the size of the tax credit, and the credit amount determines how much equity investors will contribute. Sophisticated investors understand that low-income housing will not generate significant cash flow or capital appreciation, so tax benefits are the primary source of their return. In fact, federal housing policy has combined tax incentives to generate equity investment with direct spending programs consistently since the 1960s. The Credit is simply the latest and most rigorously targeted of these tax incentives.

- Market-rate mortgage financing depends on rents and operating expenses. Rents affordable to low-income tenants are generally low -- a household earning $18,000 can afford $450 for rent and utilities -- so mortgage financing is limited. This is where project-based rent subsidies come in. If these subsidies are based on high rent standards, a larger mortgage can be supported. Mod Rehab rents are usually 20 percent -- and sometimes 44 percent -- above HUD's regular "fair market rent" standard for existing housing.

- Public subsidies fill the financing gap between the total development cost and the financing that can be raised from equity investors and mortgage lenders.

The real issue is not whether subsidies are to be combined, but whether they are too generous. That depends on the specifics of each project: the extent of rehabilitation, the project's location, and the type and amount of the subsidies. I have attached three case study financial analyses that illustrates these variations.

The typical project LISC assists involves new construction or gut rehabilitation in a distressed low-income neighborhood. Rents must be low both to be affordable and to meet the market. Project-based rent subsidies are not usually available. Under these conditions, the cost of development is far greater than low-income rents can support. Even assuming that we can raise equity investments through a tax credit syndication, we still have a substantial financing gap that only public capital subsidies can fill. These subsidies include Rental Rehabilitation grants or loans, Community Development Block Grants, or state and local government programs. (See the attached Case One.)

Adding Section 8 Moderate Rehabilitation subsidies to the mix would reduce the financing gap, but not necessarily eliminate it entirely. Because Mod Rehab effectively guarantees a rent 20 percent higher than HUD's fair market rent for existing housing, a larger mortgage can be supported than would otherwise be possible. But if gut rehabilitation is required, even the combination of tax credit syndication with Mod Rehab subsidies will not be sufficient to make the project feasible. (See the attached Case Two.)

But suppose a project needs much less rehabilitation work done. In that case, combining tax credits with Mod Rehab subsidies could well be excessively profitable for the developer. A much smaller tax credit would be available, since the credit amount depends -- and appropriately so, in my view -- on how much rehabilitation work is done. But since the total development cost is so much lower, there is a financing surplus instead of a gap. (See the attached Case Three.)

This last scenario appears to be the case with the projects GAO reported to you on August 2. Because rehabilitation costs were moderate, the full subsidy available under the Mod Rehab program and the maximum tax credit were excessive. But it would be a bad policy mistake to infer that tax credits and other public subsidies should never be combined. Most new construction and substantial rehabilitation projects require them both.

Now to the second question: How can public oversight be exercised to ensure that these subsidies are not excessive? The answer requires a combination of disclosure of information, clear accountability, and coordination.

S. 980, the Low Income Housing Credit Act of 1989, addresses the issue fully and responsibly. S. 980 is sponsored by 70 Senators led by Senators George Mitchell and John Danforth. Many of these provisions were recommended by a task force convened by Senators Mitchell and Danforth with representation from state agencies, nonprofit and for-profit developers, housing advocates, syndicators, and academic experts. The Senate Finance Committee is expected to consider S. 980 as part of its budget reconciliation package.

In summary, these provisions require:

- Project sponsors to disclose all sources and uses of project funds, including developer's fees, syndication fees, consultant's fees, and subsidy amounts and sources.

- State agencies to allocate only the amount of Credit necessary to make the project financially feasible, taking into account all sources and uses of financing.

This concludes my statement. I would be happy to respond to any questions you may have.

CASE ONE

GUT REHABILITATION PROJECT
WITHOUT SECTION 8 MOD REHAB SUBSIDIES

I. Development Cost (per unit)

Land	$ 5,000
Existing building	10,000
Rehabilitation	55,000
Total	$70,000

II. Financing

A. Summary

Equity	$26,750
First mortgage (12%, 30 years)	14,800
Public gap financing	28,450
Total	$70,000

B. Equity

1. Existing building		
Basis	$10,000	
Credit @ 4%/yr	$ 400	
2. Rehabilitation		
Basis	$55,000	
Credit @ 9%/yr.	$ 4,950	
3. Total credits/yr	$ 5,350	
x 10 years	$53,500	
4. Equity @ 50%		$26,750

C. First Mortgage

Maximum tenant income (60% of area median for 3 person household)	$17,880	
Maximum rent (incl. utilities) ($17,880/12 months x 30%)	$ 447	
Less vacancy loss (5%)	(22)	
Less operating expenses	(250)	
Cash flow	$ 175	
Less debt serv. coverage (15%)	(23)	
Avail. for debt service	$ 152	
First mortgage supportable		$14,800

CASE TWO

GUT REHABILITATION PROJECT WITH SECTION 8 MOD REHAB SUBSIDIES

I. Development Cost (per unit)

Land	$ 5,000
Existing building	10,000
Rehabilitation	55,000
Total	$70,000

II. Financing

A. Summary

Equity	$26,750
First mortgage (12%, 30 years)	33,600
Public gap financing	9,650
Total	$70,000

B. Equity

1. Existing building		
Basis	$10,000	
Credit @ 4%/yr	$ 400	
2. Rehabilitation		
Basis	$55,000	
Credit @ 9%/yr.	$ 4,950	
3. Total credits/yr	$ 5,350	
x 10 years	$53,500	
4. Equity @ 50%		$26,750

C. First Mortgage

Fair market rent (120% of proposed base)	$ 682	
Less vacancy loss (5%)	(34)	
Less operating expenses	(250)	
Cash flow	$ 398	
Less debt service coverage (15%)	(52)	
Available for debt service	$ 346	
First mortgage supportable		$33,600

CASE THREE

REDUCED REHABILITATION PROJECT WITH SECTION 8 MOD REHAB SUBSIDIES

I. Development Cost (per unit)

Land	$ 5,000
Existing building	15,000
Rehabilitation	20,000
Total	$40,000

II. Financing

A. Summary

Equity	$12,000
First mortgage (12%, 30 years)	33,600
Total	$45,600
Surplus	$ 5,600

B. Equity

1. Existing building		
Basis	$15,000	
Credit @ 4%/yr	$ 600	
2. Rehabilitation		
Basis	$20,000	
Credit @ 9%/yr.	$ 1,800	
3. Total credits/yr	$ 2,400	
x 10 years	$24,000	
4. Equity @ 50%		$12,000

C. First Mortgage

Fair market rent (120% of proposed base)	$ 682	
Less vacancy loss (5%)	(34)	
Less operating expenses	(250)	
Cash flow	$ 398	
Less debt service coverage (15%)	(52)	
Available for debt service	$ 346	
First mortgage supportable		$33,600

Senator **Graham**. Thank you very much, Mr. Roberts.

I would like to turn to an analysis of S. 890. Some of my questions you have already touched on, and if you care to elaborate.

An issue that came up in the morning testimony was the fact that when tax credits are used in soft markets, markets that have a substantial surplus of housing, that that is a particular circumstance that could lead to excessive subsidies. That led me to wonder if there should not be some allocation among the States analogous to what Ms. McFall indicated is occurring within the State of Maryland that tries to recognize that; that is, using a formula other than a per capita formula for allocation among the States to take into account the fact that some States have a relatively more severe housing circumstance than others.

I would be interested in your comments.

SOFT MARKET AREAS

Ms. **McFall**. Well, I would think that it would be extraordinarily difficult to find a national formula that would fit the kinds of cases that they think they are talking about. When you do studies like GAO does and they describe these soft market areas, it is a little hard when you are out there as a practicing houser to find these soft market areas.

I don't know any area in Maryland where rehab of housing for very low-income people is going to occur without incentives. There may be some areas in Sunbelt States where growth is declining and new construction is lessening, but I wonder if rehabilitation is needed. The whole issue of how to allocate tax credits has been—it has been lacking discussion in any forum, and the present population base reflects the feeling that that is the most equitable way to deal with it, and then within our own State's planning strategically the areas where new construction may be more appropriate versus rehab.

Frankly, I just don't understand the point that in soft market areas you may not want to construct new housing, but I didn't understand how that led to more potential for abuses with the overlap. But I haven't read the report fully.

Senator **Graham**. I don't want to put words in their mouth, but to anticipate, it goes back in part to the way in which fair market rents are calculated, which includes some historic lag; that is, fair market rents are predicated on analysis that may be 2, 3, or 4 years old. We are now in a new softer economic situation, so that the developer gets the benefit of history applied to a different current circumstance. That is one of the ways in which a soft market impacts section 8 Mod Rehab and then may result in the tax credits being excessive.

Mr. **Roberts**. What you are really talking about is not an issue so much for the tax credit as it is for the Mod Rehab Program, but let's assume that in fact you could have a problem with, say, the rents for Mod Rehab purposes. Under the proposal for Mitchell-Danforth, the States would still take a look at that project and they would still analyze how much tax credit is required to make that project work given the presence of the Mod Rehab subsidy.

So I think S. 980 already addresses the issue that is being raised here. In terms of whether there should be some formula other than population for allocating credits, I think one can make an argument that housing needs may not be uniformly the same for every State and there are other direct spending programs that HUD operates that allocate funds among States or localities on the basis of some formula that reflects housing needs and the like.

I think that may not be a bad idea. As you know, it is politically very difficult to do that, especially on an existing program, because what you give to one State you have to get from some other. So I think it would be very difficult to come up with a formula, but if you can do it, I think that there is merit in trying.

Senator **Graham**. You are certainly right about the difficulty of doing that, and you have touched on one aspect of the difficulty, and that is the zero sum game, that there is an equal group of losers for every winner.

Another problem is that almost any allocation formula other than one that could be operated by an intelligent monkey with an adding machine requires somebody to make judgments, discretionary decisions, and one of the many unfortuante fallouts of what has just happened to HUD is that there is very little confidence and I suspect little political will to give it any additional judgment and discretion.

Another issue which was raised by the testimony this morning is that the allocation formula in the Mitchell-Danforth amendments might tend to emphasize elderly housing, small unit housing, to the detriment of family housing. I believe one of the factors in the allocation is what allocations will create the most units of housing without differentiating between the types of housing—elderly, family, handicapped, et cetera.

Is that a legitimate concern?

Ms. **McFall**. I will dive into that one since we are the allocators.

I don't think that is a problem. We, for example, have selection criteria that must have been preguessing Mitchell-Danforth or we are all on the same wavelength on what would be good public policy, but our selection criteria have—is serving the lowest income for the lognest time, and just as Mitchell-Danforth says, now look at other things like the tenant populations and the special needs and modify that and give priorities based on who you are underserving relative to the needs by family and elderly.

So we haven't found that to be a problem, and it certainly is true virtually in any housing subsidy program that you have to as a matter of public policy be allocators, and the administrators of the goodies have got to keep setting policies that give priorities and pull housing back so that it will serve families because the communities are urging it, the elderly, the sponsors are finding it more attractive, and there are a variety of forces that tend to work in the direction of naturally going toward the smaller units.

So we have historically in allocating all manner of State funds and the tax credits considered the need for larger families, and it is just simply the kind of selection, multifactor selection criteria when you can give weight that balances that.

Senator **Graham**. I think the concern in the testimony today was that in the Mitchell-Danforth legislation there was specific allocation priority given to maximizing the number of units.

ALLOCATION PRIORITY

Mr. **Roberts**. I think that is under reconsideration, Senator. The problem that we have with that priority being imposed as a very strong part of the process is that, again, the size of the credit you get depends on how much rehabilitation you do. So if you say we want to look at the projects that are going to require the smallest credit per unit, what you are saying in effect is we want to look at projects in which very little, if any, rehabilitation is undertaken rather than projects that require substantial rehabilitation or new construction. We think the determination of whether the greater need is for moderate rehab, substantial rehab, or new construction ought to be made at the State level. This judgment should not be inadvertently directed through the Federal policy.

That is not to say that consideration should not be given to what the syndication fees are, what other transaction costs are, what the size of the development fee is and, given the specific nature of the project, whether these costs are appropriate or not. There are provisions in Mitchell-Danforth that address all of those issues, and they really, I think, get to maybe the more important part of the efficiency issue, the real efficiency issue, which is: is the money going into the project to the maximum extent possible and does that project really meet the local and State needs?

Ms. **McFall**. I want to put one more plug in. I do think it is correct public policy to use tax credits, in part as you evaluate them to serve the lowest income people for the longest period of time. I don't think Mitchell-Danforth would say that that means produce the maximum number of tax credit units with your allocations, but I didn't frankly remember that that was in Mitchell-Danforth because I do think that takes you to a place that you don't want to go. But an expression that you want to serve the lowest income people for the longest period of time, I think that is right on target.

Senator **Graham**. I would request that you might look at that specific provision, and if you could supplement your remarks with any suggestions of how you think that allocation formula should be modified in order to accomplish the objective that you just stated, I would be very interested.

A related issue was one that was raised in one of our previous hearings by the former administrator of the housing program in Dade County, FL, in which he expressed a desire that these various forms of subsidy and credits be applied against a locally developed plan which stated local housing goals and intended to use available resources to maximize those goals.

As an example, he indicated that he felt that failure to have such a relationship had resulted in less housing being built in the inner city vis-a-vis suburbs, less housing for families vis-a-vis housing for elderly.

Do you have any comment about the degree to which a closer relationship between allocation decisions and a locally developed housing plan should be required?

Ms. McFall. I would love to comment on that one.

I assume this was Mel Adams. We are pleased to have him run in Maryland. I am sure that he must have spoken of his frustrations that he has felt in recent years, comparable to the kinds of frustrations I felt, that the delivery of housing subsidies was made far away and using criteria that we are just coming to fully understand. Those of us who are responsible for meeting the housing needs of our States need greater control, we have greater ability to develop plans, priorities, selection criteria, and work with our local governments to get the right housing in the right places. We certainly have not had a policy which has been conducive to that in recent years.

The Mitchell-Danforth provisions seem to me to provide the process for doing that, and as I understand discussions about other legislation you are considering, there are similar thoughts in that legislation.

ONE PROCESS IS NEEDED

I would just make the appeal, please, could we have one strategic planning, needs assessment, selection criteria process for all of the Federal programs. We don't need six. We just need one comprehensive, good, careful public process where we lay out where we want to go within out own States.

Senator Graham. Is there currently a requirement for the development of such a strategic plan with goals implementations?

Ms. McFall. No. The present tax credit program has no requirement. That would be a new addition.

Senator Graham. Is there a requirement elsewhere that local housing agencies use?

Ms. McFall. No. If you apply for various Federal programs, you have to do little plans for the subdivision in which the project might go or other Federal planning, but there is no overall plan required. We used to have MRB's. They are now abolished. MRB is mortgage revenue bonds, single family tax-exempt bonds. We used to have requirements to do a plan, and that subsequently, I think—I believe that finally has been eliminated.

And really the direction that there should be a single, unified statewide plan I think would be an excellent addition for your programs as well as ours.

Senator Graham. That might be a more appropriate provision to consider in the major housing legislation that Senator Cranston will be proposing later in the year.

Ms. McFall. It might well be.

Mr. Roberts. Senator, I would like to see your bet and raise you one. We think there ought to be sub local plans as well. We have very scarce resources to work with. They need to be used as strategically as possible. Community development groups work just that way. They have a neighborhood strategy. It is logical. It takes one project first to make a big impact in the community and then another project to build on that, and it creates some real momentum in low income neighborhoods.

The low income neighborhood is where most low income people live. So if we care about the availability of housing resources for low income people, we have to make sure that their neighborhoods are stabilized. That is critical.

Look at Liberty City and what has been going on over there in the last couple of years with a couple of very strategic projects, a key shopping center, some new construction housing, very prominent, that has an enormous spinoff effect on the entire neighborhood. To scatter housing resources far and wide without regard to that kind of a strategy means that you lose all of those spinoff effects, and I think we need to come back and recognize that housing exists in places, in neighborhoods, and to divorce community development policy from housing policy is not an efficient use of Federal resources.

So I would endorse that strongly.

Ms. McFall. Could I add one caveat?

I feel I can say this because I did my 10 years as a planner. I hope that we don't take our enthusiasm for having a more rational role and then later on submit planning requirements to those of us whose job it is to develop and do things that will return to the 1960's where all we did was plan. It made me slightly nervous when we think of layers and layers of plans. I think one good strategic plan is a fine thing and that we shouldn't get ourselves too carried away with planning.

Senator Graham. As I indicated, I suspect that this issue is more likely to be taken up in a comprehensive housing act rather than what this special review of HUD Moderate Rehabilitation will do. I make that comment as an anticipatory one to you that you might be called upon for some further suggestions on that specific issue in the near future.

Ms. McFall, you stated the proper enforcement agency for the Tax Credit Program as being the IRS.

What does the IRS, let's say the Baltimore office, do to monitor the fact that taxpayers who are claiming low income tax credits are in fact providing the housing for the people who are eligible?

IRS MONITORING

Ms. McFall. You are just about to go out of my area of technical expertise. I think I know that once a year the owner files the appropriate forms with the IRS which certify that the units are in compliance with the other required information.

I don't know if anybody else can help me any more on that.

Senator Graham. When the previous speaker had thought that a public housing authority or some other local agency was doing that enforcement, it struck me that that would be a more appropriate agency to do that than would be the IRS based on the orientation of the agency and the likely expertise of its staff.

What would be your response to having some other agency, by delegation or otherwise, charged with seeing that there had been compliance?

Ms. McFall. Well, very mixed feelings. I don't think that I can argue that the expertise of project oversight is not something that housing finance agencies have the capability to do because all of us have extensive portfolios of housing projects for which we have been the lender, on which we keep a careful eye, including compliance with the income requirements related to the programs that are financed.

I think in the case of the tax credit program, however, where it is a tax compliance issue, it would seem to me that the correct decision was made that it is between the IRS and the owner/sponsor and investors and it is not inappropriate for that role to occur between them.

Now, we do not get off—and I think our agency is probably close to typical of others—we don't get off anywhere scot-free. We are the lender on half of the tax credit projects in our State because we have so many State programs, and of course we are monitoring those in our capacity as lender and we have oversight for the duration of the mortgage. But for the other half where we are not the lender but are simply the allocator, it is a relationship between the IRS and the developer.

Just some pragmatic administrative concerns. I shudder to think of the amount of tax credit fee you would have to collect, as the allocator would do up front or over the years, to be able to cover your staff costs on an ongoing project oversight that we now have for projects in which we are the lender. It would be a big workload for our agencies.

Senator GRAHAM. It has been observed that sometimes legislators spend more time solving nonexistent problems than problems that really exist.

Do you sense that this is a nonproblem, that in fact those developers who have received tax credits in order to provide housing for certain people are in compliance and therefore there is no need for a change in the current supervisory relationship?

Ms. MCFALL. To be honest, I don't think that we know the answer to that. The program is too new. The projects are just being constructed, being rehabbed. We really don't know.

Mr. ROBERTS. I would agree with that. The real enforcement mechanism is the threat that the IRS is going to find out, and when they come looking for you, you don't want to be around, and so that has been the traditional enforcement mechanism. IRS does keep a closer eye on these kinds of tax motivated investment transactions than on other things, and I agree that we don't know yet whether there is a problem.

Ms. MCFALL. Can I just comment on the GAO's testimony?

I think one of the speakers said that the only thing they can do is recapture. That is the only thing but that is an enormous penalty. Not only can it cease allowing tax credits to be claimed in the future, but to recapture all benefits for going out of compliance. I would not attach the word "only" before that. The IRS has the biggest hammer that you could hope to have if you go out of compliance, and I think sponsors will do everything in their power to never get near that penalty. That would be a financial disaster.

Mr. ROBERTS. Let me speak from our perspective on this, as a charitable organization that has relationships with corporations who are investors. If we don't do a good job of keeping on top of these projects and making sure they serve the people they are supposed to serve, making sure the investors do get the tax benefits that they have bargained for, we have a major problem because these are not simply investors with whom we never have to have any more dealings. Our credibility as a charitable organization is on the line, as well as our ability to raise money from the private sector.

So we can't afford to make mistakes on this.

Ms. McFall. There are those who say the fact that the tax credit syndication brings in a number of investors that there are even more eyes and ears to make sure that compliance is underway.

Senator Graham. I have some additional questions prepared, but as I review them in the context of the responses that you have made in your opening statements, you have been so comprehensive that you have illuminated any shadows of doubt or uncertainty, and with that I am thankful.

Thank you very much. I appreciate your participation today.

If you would like to supplement the record with any additional comments, if you are of a mind to provide some further thoughts relative to the Mitchell-Danforth legislation or that which will be developed through Senator Cranston, we would be appreciative.

[Witness excused.]

[Whereupon, at 12:40 p.m., the committee was adjourned.]

ABUSES IN THE SECTION 8 MODERATE REHABILITATION PROGRAM

TUESDAY, OCTOBER 31, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 2:55 p.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Graham, Dixon, and D'Amato.

OPENING REMARKS OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order. And I want to draw attention to a news release dated today that we are putting out that, in a sense, is an important reference to today's meeting and all further hearings of this kind that will follow.

And that release, which I now summarize orally, is that the Senate Banking, Housing and Urban Affairs Committee, this committee, has created a special subcommittee which will continue the investigation into program abuses at the Department of Housing and Urban Development.

We have been underway now in the committee for some months with a series of hearings looking at the problems in HUD in trying to understand the full nature of the pattern of the abuses and how they came about and how they could be stopped and safeguarded against in the future.

Our committee hearing today is the sixth such hearing. In setting up this special investigating subcommittee for this express purpose, I have asked Senator Bob Graham, who is here, to serve as the chairman of this effort. And he has shown great leadership on this issue now over a period of months, and I'm convinced is the person who can spearhead this effort within the committee.

Serving with him is the ranking minority, will be his colleague, from Florida, Senator Mack. Other members of this special subcommittee will be Richard Shelby and Richard Bryan, and also Senator Chris Bond.

I would note that all other full committee members will serve as ex officio members of this subcommittee, so that members are free and invited to participate as they can and are able to as the subcommittee does its work.

But, Senator Graham has been the point man for the committee's investigation since May and his tenacity and great skill I think has not only helped focus the investigative effort thus far, but will increasingly do so here in the future.

So, with that, let me just yield to you, Senator Graham, for any comments you want to make. And then, at an appropriate point, I will want to make an opening statement with respect to today's hearing.

OPENING REMARKS OF SENATOR GRAHAM

Senator GRAHAM. Thank you very much, Mr. Chairman. I appreciate the confidence that you have placed in the members of the committee who will be sharing the responsibility for this special task. This is an extremely important question because it goes to the credibility of Government, the ability of the Federal Government to play a significant role in meeting one of the most serious of our Nation's social problems—adequate housing and quality communities.

This committee has legislative jurisdiction over most of the issues which this investigation has thus far surfaced and which will be reviewing in our future hearings.

I think, therefore, it's very appropriate that, in the Senate, that this committee take the leadership in correcting these abuses in seeing that our limited funds for housing go to those in need rather than those who see this as an opportunity for personal greed.

I look forward to working with you and the other members of the committee in carrying out this important undertaking.

Mr. Chairman, you indicated that you have an opening statement?

The CHAIRMAN. I just have a brief opening statement, and then——

Senator GRAHAM. Good. I will have one also.

The CHAIRMAN. And then I think, in the order of the establishment of this special subcommittee effort and with you as its head, that, after I complete my statement, I'm going to pass the gavel over to you so that you conduct this hearing as you have some of the previous hearings.

Senator GRAHAM. Thank you very much, Mr. Chairman. You have said in your opening statement much of what I have in mind and, therefore, it will be my intention to file my opening statement for the record.

As one who had the responsibility for 8 years to be the chief executive of a State where it was the responsibility of the elected chief executive to determine that the executive agencies were operating in accordance with law and to carry out their intended purpose, it has come as a shock to me to see that abuses of the scale that we have found in this department were occurring with apparent impunity, immunity and a lack of recognition by those who have the responsibility for their oversight.

As this committee has the legislative jurisdiction for the Department of Housing and Urban Development, one of the questions that we will be exploring today and possibly in future hearings is what steps need to be taken in order to assure that there will not be such a massive failure in oversight in the future.

We will be interested in talking with those who will appear today as to what is the current status of oversight of this agency, and then looking into the past, what were the circumstances that caused the derelictions of public trust to be undetected in previous administrations.

Mr. Chairman, I will file the balance of my statement for the record.

Senator **GRAHAM**. I have statements for the record from Senators Dixon, Sasser, and Garn.

[The statements of Senators Riegle, Graham, Dixon, Sasser, and Garn follow:]

PREPARED STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

This morning we conduct our sixth hearing into the Mod Rehab program focusing today on the oversight role of the Office of Management and Budget and the White House. Major questions need to be resolved regarding the role of OMB and the White House during the time when scandalous activities at HUD were taking place.

During the past 8 years, OMB has played a significant role in determining and shaping national policy. As an arm of the Reagan White House, the agency's prominence and influence increased enormously. And I think it is a fair assessment to state that no Federal agency made a move during the Reagan administration without first clearing it with OMB.

Yet, at a time when OMB was experiencing increased oversight responsibility, it seems peculiar that they could simply overlook HUD's massive mismanagement problems. Secretary Kemp has estimated that the losses to HUD and the Federal Government are about $2 billion. Furthermore, in recent hearings before this committee, it has been revealed that there are significant problems with the FHA fund. The question is—where was OMB and the White House when billions of dollars were being lost through mismanagement? What happened to the internal checks and balances that are supposed to guard against these things happening?

I look forward to hearing from our witnesses this morning, and I will yield to my good friend from Florida, Senator Graham.

PREPARED STATEMENT OF SENATOR BOB GRAHAM

Good Afternoon. Today we continue our investigation into the Department of Housing and Urban Development's Moderate Rehabilitation Program. Prior hearings have focused on the cheese that attracted the rats—the incentives that attracted people outside of HUD to compromise the integrity of a program designed to help poor people. Those hearings revealed statutory and regulatory flaws and a program ripe for abuse.

Many disturbing questions have been raised throughout the course of these hearings. Such as—How were unscrupulous developers and consultants able to line their pockets with scarce Federal dollars intended to help the most needy? How were top HUD officials able to hand out hard earned taxpayers' dollars to their friends and political allies? How could billions of dollars be squandered through fraud, abuse and gross mismanagement and no one even noticed it? The reason is simple. No one was watching the store.

The Office of Management and Budget and the White House are responsible overseeing HUD. Today's hearing will focus on their roles in the Moderate Rehabilitation Program and, hopefully, shed light on how HUD's massive management problems escaped OMB's and White House's usually watchful eye.

When the Reagan Administration took power, it declared it would be champions of improving the management of the Federal government by doing more with less and eliminating waste, fraud, and abuse. As a result, the role and prominence of the Office of Management and Budget increased significantly. Executive branch agencies were required to obtain OMB approval of any significant changes in operations. Given this intense level of scrunity, it is unclear—almost unphathomable—why the problems at HUD weren't spotted earlier.

Today, we will be examining the role of OMB and the White House and attempt to gain some understanding of why these oversight entities were unaware, unconcerned or simply failed to take the appropriate measures to address the management problems at HUD. We need to know if the prescription for this lack of oversight should be no-doze, a pink slip, or a jail cell.

PREPARED STATEMENT OF SENATOR ALAN J. DIXON

Mr. Chairman, as we continue to investigate abuses in the section 8 Moderate Rehabilitation (Mod Rehab) Program, I commend you for your leadership and perseverance.

We will have before us today witnesses who will discuss the duties, responsibilities and monitoring of the Office of Management and Budget (OMB) in overseeing the activities at HUD. They will also discuss the role of the White House with respect to HUD programs.

As we know, since 1980, Federal funding for housing programs decreased by approximately 80 percent. During this time, the administration proposed elimination of the Mod Rehab Program.

Mr. Chairman, I especially look forward to the testimony today as we attempt to solve the mystery of how the previous administration permitted the blatant uneconomical use of our scarce housing dollars. From this, I hope that we will learn how the duties, responsibilities, and monitoring at OMB and the White House can be improved.

PREPARED STATEMENT OF SENATOR JIM SASSER

Mr. Chairman, I'm pleased that the committee is continuing its review of the mod rehab scandal at HUD. Indeed, today we have witnesses from the agency that should have known about the abuses at HUD—the Office of Management and Budget.

We often forget that the word management is in the name of OMB—I know that on the Budget Committee we certainly tend to. But management should be an important role for OMB.

OMB let the Mod Rehab Program be turned into a political feeding trough. There was blatant favoritism involved. OMB didn't even make sure that regulations were promulgated for the program. Clearly, regulations could not have made the situation worse.

When scarce taxpayer funds are being misused by an agency OMB should be on top of it. Mr. Chairman this is really the scandal: if mod rehad funds had not been syphoned off to top Republican consultants many, many poor families could have been housed.

Mr. Chairman, thank you for your testimony. I'm interested in hearing from the witnesses about this scandalous misuse of Government funds.

PREPARED STATEMENT OF SENATOR GARN

Mr. Chairman, I am pleased to continue our hearings into the Moderate Rehabilitation Program. The hearing today focuses on the oversight and monitoring of this program by the Office of Management and Budget and the White House. We have all learned our lesson from the past abuse of this program. I look forward to working with you, Mr. Chairman, and the current administration to turning around problems of the past.

I must commend the President, Secretary Kemp, and Richard Darman for their quick and effective response to the management and programmatic deficiencies at HUD. Secretary Kemp's reform proposal embodies key elements to ensure that the American taxpayer will not be throwing money down the drain. In addition, it ensures that Federal housing funding is going only to those who truly need it.

I have been equally impressed by Richard Darman's response to these problems. The current OMB has made a number of changes to focus attention and energy on the management of all Federal agencies. In recent testimony before the Senate Government Affairs Committee, Richard Darman stated his clear commitment to turning around management problems in the Federal Government. He has asked for more staff to focus on management and he has received additional funds for this purpose in this year's appropriations' bill. In addition, he is working toward better integration of management and budget functions. This has been a key problem with the Moderate Rehabilitation Program and housing programs in general.

I continue to welcome additional oversight efforts as they relate to all Federal programs, and I look forward to working with this administration to ensure that Federal dollars are used efficiently for their intended purpose.

Thank you, Mr. Chairman.

Senator GRAHAM. Our first panel is Mr. William Diefenderfer, Deputy Director, Office of Management and Budget.

The CHAIRMAN. Mr. Chairman, might I, if you'll indulge me for one second, I want to just join you in welcoming Mr. Diefenderfer to the committee. He's a person well-known to me and I think to the committee, and whose been around this time and a person of very high reputation and standing. And we're pleased to have him before the committee today.

WILLIAM M. DIEFENDERFER III, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, WASHINGTON, DC

Mr. DIEFENDERFER. Thank you very much, Mr. Chairman.

Thank you, Chairman Riegle again, and Senator Graham, and other distinguished members of the committee who were responsible for inviting me to testify today.

It's a pleasure to be with you to discuss the review of the Office of Management and Budget of the activities of Cabinet level departments, independent Federal agencies and to identify areas vulnerable to fraud and waste.

I would also like to give you from the OMB perspective a sense of the efforts underway to improve the management and operations at HUD.

With your permission, I would like to make a few summary points and observations and ask that the balance of my prepared statement be entered into the record.

Senator GRAHAM. Without objection, so ordered.

Mr. DIEFENDERFER. Thank you, sir.

The management problems of the Federal Government are enormous. Concomitantly, the oversight responsibilities for Government management are at least as large. There's been a massive failure of collective oversight responsibilities, which includes OMB.

Collective oversight has failed for several reasons, which include what the Director of OMB called in his testimony before a Senate committee not too long ago, the Hollywood east syndrome, which is too many people in positions of political responsibility who are infatuated by the life of glitter and lights and not the more pedestrian work of management.

What I call the raison d'etre syndrome, which is departments, agencies, administrations and committees come to treasure the programs that they administer, authorize or fund to the extent to question the values of those programs is to question their own reason for being.

You always hurt the one you love syndrome. I think there's a great irony in this syndrome. Strong, policy-driven supporters of programs from defense to domestic entitlements are often the least likely to support inquiry into the shortcomings of those programs, whether the shortcomings be policy or management-based.

Those who hold strong, policy-based objections to such programs revel in exposing their foibles and shortcomings, hoping to open the overall program to attack. The irony lies in that, by trying to protect or shelter a program from criticism, a proponent ultimately weakens his case.

And, finally, the need for the professional critic. There needs to be a detached, continuous review of all government programs and their management. OMB, for one, should provide such a review. Even though well-intentioned, the M in OMB has not been well-tended over the years.

In 1970, OMB had 224 people on the management staff in oversight functions. When I came to OMB early this year, this number had shrunk to 47, a reduction of 80 percent.

My testimony speaks to the steps the Director and I have taken to reverse OMB shortcomings.

The balance of my statement for the record addresses problems at HUD, the OMB management oversight role, the OMB management integrity program, the Presidential management by objectives program and financial management and improvements.

Thank you very much, sir.

[The complete prepared statement of William Diefenderfer follows:]

Supplement for the Record

The Problems at HUD

The problems at HUD became highly visible in June, but most of them were known much earlier. They had been reported by the HUD Inspector General or in reports under the Federal Managers' Financial Integrity Act, as early as 1983. Problems in Federal housing programs are also not new. It is worth remembering the problems in the FHA of the mid Fifties -- the Commissioner had to resign -- and the cost over-runs of HUD's urban renewal program in the late Sixties.

The recent problems at HUD involved four major program areas: the moderate housing rehabilitation program, closing agents cash management, the FHA multi-family co-insurance program, and the Title X Land Development Insurance program. The problems in these areas included non-competition and political influence; over-payments; embezzlement; high default rates, and politically motivated and flawed insurance underwriting.

Very much to his credit, Secretary Kemp has taken action. He announced a series of wide ranging reforms in June. And, on October 3, he announced over 50 specific management and program initiatives. Some of these will require legislation but many are already underway and others can be accomplished administratively.

The October package covers three broad areas:

(1) Ethics Reform: This includes sunshine policies relating to HUD decision making, allocating housing and community development assistance by formula so as to make it less subject to influence peddling, registration of consultants, and increased resources for the Inspector General.

(2) Financial and Management Reforms: This includes the appointment of a Departmental Chief Financial Officer, transfers of resources to enhance program evaluation, streamlining of the regulatory and audit functions, and increased funding for the truly needy under the Community Development Block Program.

(3) Reform in the Federal Housing Administration: This is designed to make the program more sound financially, and to target it more toward those most in need. Reform also includes the appointment of an FHA Comptroller.

Secretary Kemp has seized the initiative, but there is a long way to go in implementation. We plan to work with the Secretary in these areas and monitor progress. HUD staff has requested OMB's help in designing their CFO and financial management proposals and we have met with them on this. It is imperative that HUD continue these efforts over the long haul. This will require sustained policy-level attention, staff motivation and improved controls. For example, additional controls may be needed with respect to FHA mortgage insurance of hospitals and greater capital reserves may be indicated for private co-insurers in the FHA multi-family coinsurance program.

OMB Management Oversight

Let me begin by stating that in the past OMB has not done as well as it should in this area. OMB's shortcomings are not unique. The Federal Managers' Financial Integrity Act has since 1983 provided for reports to the President and Congress on material weaknesses in internal controls; the Inspector General Act has required semi-annual reports to the President and Congress on investigations and audits. OMB has in the past received those reports and filed them. But until this year, we did little to review them and to follow up.

Part of the problem was attributable to diminished staff resources. As you may be aware, the management staff at OMB was reduced from 224 people in 1970 to 47 in 1989, a reduction of about 80%. Indeed, the OMB management staff is less than one half what it was a decade ago.

We are remedying this problem. We requested and our Appropriations Committees concurred in, an increase of nearly 50 FTEs for OMB of which 30 will be allocated to management. The Director and I firmly believe that these additional resources will help us improve oversight of the highest risk areas.

On October 5, 1989, Director Darman testified before the Senate Governmental Affairs Committee as follows:

> "Whether governmental performance is better or worse than the private sector's -- after adjusting for differences of scale -- is arguable. But that is irrelevant. The governmental management problems are more than serious enough to merit greater attention. Indeed, they present not only issues of efficiency and integrity; but also issues that ultimately can affect the basis for confidence in democratic government."

Let's now consider the issues of general oversight of Federal management. There presently exists a great store of information regarding a wide variety of problems throughout the government. Whether the sources are GAO reports, IG audits or investigations, or agency internal evaluations, the key is to focus attention on that information and to act upon it. It seems to me there are three key principles:

> First, ensure the attention of the heads of Departments and Agencies, and in particular their Deputies, to management and the use of such tools as internal controls and audit follow-up.
>
> Second, improve our management information systems and our ability to cull in a timely fashion from the enormous magnitude of

existing data the key information on the most critical and highest risk issues.

Third, improve our collective oversight and increase our senior policy and program attention to critical indicators of incipient problems; management is the responsibility of policy and program officials not just those designated as managers.

The bright side of the problems at HUD is that they have provided real impetus to high level attention to Government integrity. In that limited sense, the surfacing of these problems early in the Administration has helped us all. At OMB, we were able to use the attention given to the HUD problem as a way of galvanizing the attention of the other agencies at the most senior level.

Management Integrity -- Focus on the Highest Risk Areas

Within days of the public surfacing of the HUD problems, Director Darman called a White House meeting of Deputy Secretaries and the Deputy Administrators of EPA and NASA to engage their personal review of internal controls and audit follow-up. I attended that meeting. The Director asked HUD Deputy Secretary DelliBovi to brief the other Deputies on the HUD problem. He also told the Deputies that he wanted them personally to work with their Inspectors General, Assistant Secretaries for Management and Chief Financial Officers to personally assess their internal control and audit follow-up procedures and programs, and report back.

The Director also noted that approximately 2200 material weaknesses had been reported by Departments and Agencies since the inception of the reporting requirements under the Federal Managers Financial Integrity Act passed in 1982. And over 450 of those remain uncorrected with little certainty that the government was focusing on the most critical items. The President later followed up with the Cabinet, underscoring the importance he personally attached to integrity in Government.

OMB's Executive Associate Director Frank Hodsoll, requested similar reports from the 52 independent agencies on July 14. And during July and August, I personally met with each Presidentially appointed Inspector General on a one-on-one basis to discuss their concerns. As you know, I chair the President's Council on Integrity and Efficiency which is the coordinating body for the Inspectors General.

The Deputies' reports are in. We have reviewed with each of the Departments, as well as EPA and NASA, lists of the highest risk areas with the potential for the most serious management and program difficulties. These areas were selected from a variety of sources including GAO Reports, IG audits, and internal management studies. Our purpose was to obtain agreement on which were the most vulnerable areas and then devote significant attention to correcting those vulnerabilities. OMB will track these highest risk areas, and OMB budget staff has been directed to give priority to providing the resources needed to remedy the problems. While it is certain that there will be future incidents of fraud or waste, we do believe we can reduce these incidents and begin to focus on corrections and prevention.

The Presidential MBO Process

In addition to this effort to focus on areas of high vulnerability, the President has initiated a Management by Objectives (MBO) system. The President's objective is to provide for a system to track selected policy and management initiatives from the time of their formulation and announcement to their ultimate conclusion.

While many of the objectives in the President's MBO system involve program and policy initiatives, a number concern management. There is an MBO specifically aimed at improving the effectiveness and integrity of programs and services for the public. This MBO will focus on several key elements that will go a long way toward ensuring that the basic financial and informational processes of government are well managed. The key elements are as follows:

(1) The installation and operation of an integrated, government-wide network of financial management systems by 1992. This will help move Departments and Agencies toward operating with similar and consistent systems.

(2) The development of data bases which integrate program results, budget, and accounting data to improve top management's decision-making capacity, by 1993. These activities will enable the government to use accurate financial and program data to improve its ability to judge the effectiveness of programs in reaching their intended clients.

(3) Increased attention to internal control programs as well as audit follow-up requirements contained in the Inspector General Act Amendments of 1988. This effort will focus the quality of internal control programs as well as senior management attention to these issues.

(4) Better use of audit as a key management tool for assessing program performance and accountability. Audit is often viewed as an entirely negative process. We hope to focus managers' attention on audit as a method of improving program operations.

Leadership in achieving the management and integrity MBO will be the responsibility of the President's Councils on Integrity and Efficiency and Management Improvement which I chair. We are establishing milestones for this MBO now.

Financial Management Improvements

A key concern, and one that is fundamental to the long range improvement of federal management, involves the area of financial management. The financial management systems of the Federal government have not kept up with the growth and complexity of government operations. As examples:

-- We were unable, during the recent deliberations on funding for the President's drug eradication program, easily to provide current data on unobligated balances. We were forced to collect data from a large number of disparate agency systems, including manual extraction of data from program and regional offices.

-- We are often unable to aggregate information in ways that permit meaningful programmatic conclusions across agencies. It is, for example, impossible easily to compare unfunded liabilities of Federal credit programs or to track debt collection efforts (administratively and in terms of legal process).

-- Inventory and receivables systems are often unable to assure adequate controls.

Improved financial management systems are essential if we are to achieve oversight of the necessarily large delegations of authority in the Federal enterprise. We plan:

-- to upgrade the OMB and Treasury central systems (MAX and STAR) and move toward a single, government-wide network of financial management systems.

-- to pursue cross-servicing arrangements whereby agencies with well-functioning financial management systems might provide services to those that do not have such systems.

-- to develop government-wide loan delivery and credit management systems -- to serve the public better, reduce costs, and provide more accurate and timely information about the performance and costs of each lending program.

-- to expand the use of private attorneys to assist the Department of Justice in the collection of debt owed the United States, and encourage access to HUD's credit alert system which allows prescreening of direct and guaranteed loan applicants credit-worthiness; and

-- to improve service to recipients of Federal benefits, such as through automated teller machines.

At the suggestion of the Comptroller General, Director Darman recently convened a meeting of principals of the Joint Financial Management Improvement Project (JFMIP) to discuss the JFMIP agenda for the future. The principals are the Secretary of the Treasury, the Comptroller General, the Director of the Office of Personnel Management and the Director of OMB. They agreed:

-- to accelerate, wherever possible, the work already underway to improve Federal financial management;

-- to implement the Core Financial Systems Requirements document issued by JFMIP in 1988; and

-- to develop and implement standard terms and definitions for financial information and minimum uniform financial information requirements.

CONCLUSIONS

In summary, efforts at OMB to review the activities, departments, and agencies that are vulnerable to fraud and waste are designed to focus the attention of the most senior level executives on improving their agencies' processes of detection and correction. The effort includes:

- Agreement on lists of highest risk areas.
- A early warning tracking system that OMB will use to assess specific progress in implementing corrective actions.
- A more aggressive and integrated review process within OMB to assess integrity issues and where appropriate ensure adequate resources for dealing with them.

We have made management and integrity a critical part of the President's MBO system and have committed the Administration to improved financial management.

Finally, we have made the decision to invest more heavily in the management side of OMB and our Appropriations Committees have concurred. We have created an Executive Associate Director for

Management and strongly support the additional step of establishing by legislation a Deputy Director of OMB for Management. We are committed to integrating to a much greater degree our budget and management functions.

While no one can guarantee all will go well, we hope and believe it will go much better. It must. OMB's role must be focused and must address those issues that are the most critical to the basic integrity of government operations. As we build this program over the next years, it is our hope that we can move further toward a prevention system and away from a reactive process blind to a longer view of government excellence.

We appreciate the bi-partisan spirit we have received from the Congress on these activities. We need to maintain such a dialogue to ensure that we approach these serious issues in a unified manner.

Senator GRAHAM. Thank you, Mr. Diefenderfer.

In looking at your stated reasons for the failure of collective oversight, given the fact that most of the people who were most involved in the pernicious occurrences at HUD had previously advocated termination of the various programs, they were not in the category of those who were zealots for the program and, therefore, lost the ability to be objective.

From your review of what's occurred in HUD over previous years, do you think that the Hollywood east syndrome was so glittering that it alone was enough to cause the indiscretions that have surfaced?

Mr. DIEFENDERFER. Absolutely not. It is a contributing factor. I would say another example of a contributing factor would be the raison d'etre syndrome.

In 1983, the IG put before everybody—not just OMB or the administration—but before the world his analysis of problems that had occurred. And since then, similar analyses have come forward from the IG and in other reports of management failures.

Many people didn't want to read those. They weren't interested. They're now interested because of the scandal quality of the event.

We at OMB acknowledge that we had a major shortcoming in this area. Those reports were filed and we essentially looked at the report and said: "Oh, yes, the IG says there's problems with the Mod Rehab. He's filed his report. The Assistant Secretary for Management has acknowledged there are some problems in this area, some material faults. He's acknowledged that."

And we checked the block off and said "File the report," and didn't follow up on it.

That is our shortcoming. I'll leave it for others to address why they didn't look at these reports, analyze the reports, exercise their oversight responsibilities and move forward on them.

But it's clear that many others did not do that also. So I think it's several of these different reasons. And then the reason that you threw in—or not throw in, but discussed earlier, which is just flat-out greed.

And that's not acceptable at any level of government, obviously, but it was present.

Senator GRAHAM. It would not be acceptable in a State government for the chief executive officer, who had been found to have presided over an agency so swept with fraud as HUD appears to have been, to have said that it was the responsibility of persons at lower levels to see that these matters were attended to.

MANAGEMENT CONTROLS AND RESPONSIBILITIES

Could you review for me what management controls were in effect from the President through the Office of Management and Budget to determine that, at each step of the process, that those below were carrying out their proper responsibilities?

Mr. DIEFENDERFER. Well, the answer to that question is a short answer. There weren't many, sir.

First you must look at what OMB is set up to do and the resources we have with which to do what we're supposed to do. We have two sides of the house. We have the management side of the house and the budget side of the house.

On the budget side of the house, we have four to five examiners who are responsible at any point in time for all of HUD. To give you a comparison, the IG in HUD has 400 and some people alone. The committees, the House and Senate committees of jurisdiction, have seven or nine, depending on which committee it is, to deal with HUD at any point in time.

On the management side, as I mentioned, the attrition had occurred on the management side to where we had, instead of some 240 looking at programs governmentwide in 1970, it had gone down to 40 some.

The oversight and review, as near as I can resurrect, was to be conducted on the management side. We have changed that in new OMB, where we're making both the management and the budget side coordinate review of agencies. But, in the past, it didn't seem to be that way, from what I've been able to establish.

And the only review that was done was what I mentioned before. The reports would come in from the IG saying there was a problem. It would be noticed and say, oh, yes, this is a problem; it wasn't followed up on.

The same with reports from the Assistant Secretaries of Management. So, there was precious little oversight or followup, as near as I can ascertain.

Senator **GRAHAM**. And at the level of the Director of OMB or those to whom that individual was responsible, were there any indications of this inadequacy of staff in order to accomplish the objectives and give to the American people their justifiable confidence that these programs were being properly managed?

Mr. **DIEFENDERFER**. Well, to be fair, I think there was. In the latter years, there was an effort to revitalize the management side of OMB and we inherited that. I think that started in a significant way in the last 2 years of the previous administration.

Additionally, there had been requests in the past by OMB to the parent committees, both Appropriations and Authorization, for increased funds for more people.

In the past, those were sometimes honored and sometimes not. I would mention that this year, however, both our authorizing parents and our appropriating parents have analyzed the problems and have seen that we do need more resources, and have seen fit to grant them.

It's in an appropriation bill that is now in conference.

ADEQUATE PROCEDURES AND STAFF

Senator **GRAHAM**. Is it your statement that you believe that adequate procedures and adequate staff to see that those procedures are carried out are currently in effect as it relates to this Department and the other Departments under the responsibility of the executive branch that a similar circumstance to that which has occurred in HUD will not occur in the future?

Mr. **DIEFENDERFER**. Well, I can't answer that question responsibily in a yes manner, sir. First of all, the request for extra staff and the money to fund that staff is not yet acted upon. That's held up in an appropriations bill which will come soon, hopefully, within the next month or two. And then we will have one component of what we need.

A second component is we are entering into a number of development activities within OMB. You can't snap your fingers and get this attitude instilled about management being the most important, or a very important part of running Government and have it happen overnight. There's a culture you have to build up. We are attending to that.

There are systems that have to be developed to track these problems. As I mentioned, even if we get the complement of staff that we want, in the housing area, for example, we may have a total of 10 people that will be able to give full time and attention both on the management side and on the budget side.

And for them to be effective, it takes tracking systems, financial controls. We are moving forward on those, but those are not in place at this point in time.

Secretary Kemp is doing the same thing at HUD. Many of his reforms are not in place at this point in time. I can say I think with some confidence, personal confidence, that if the objectives we set out are achieved, and I think they can be achieved over the next 6 to 7 months, assuming we get some of the legislation that Secretary Kemp needs in terms of reforms, we will have an adequate system to make sure this does not occur in HUD again.

Governmentwide, I can almost assure you that something like this will happen again. We will make mistakes. We will miss them But, hopefully, not on the scale that we have in this instance.

I would say as an example, there are those who think that the FHA funds may be in serious trouble. Now, it's not necessarily a management problem. It could be. It could be management and policy.

We are analyzing that now. It is a problem that, if it is as significant in scope as some think, has been created in the past and that will blossom at sometime in the future.

One of our objectives when we pulled all of the departmental deputies in and the President brought the Cabinet Secretaries in and told them that management was one of his highest objectives—he wanted a complete review of their departments. He wanted them personally to look at the IG report and the management reports to see what their predecessors said was wrong and address it—was to raise the visibility of the high-profile risk areas.

We are doing this with every department in Government now—major and minor—are identifying risks and agreeing between ourselves, between OMB and the Department, that these are the high-risk ares. And we have taken the responsibility of monitoring the progress they take toward addressing those risks.

We are going to identify problems. There are going to be other things for you to handle or consider, which you will find distasteful, as we will find distasteful, so there will be eruptions down the road. Hopefully, we can decrease the amount of activity of that nature.

Senator GRAHAM. All of the reforms that you have just enumerated are being conducted under the same law that has existed in the last 5 plus years?

Mr. **Diefenderfer**. Well, I enumerated [illegible]me reforms that the Secretary wishes to initiate at HUD. And I believe he has asked for legislation. Some of those do take legislation. The ones that we at OMB are pursuing, yes, we are doing it under existing law.

Senator **Graham**. So, assumedly, all those steps could have been in place during the period when most of the questionable activity was occurring?

Mr. **Diefenderfer**. Without a doubt, sir. I acknowledge in my statement that OMB failed in the past in its oversight responsibilities. I also said in my statement to be fair to OMB that they aren't the only ones who failed.

This burden is shared widely. We need governmentwide a new attitude toward oversight.

Senator **Graham**. When my time is up—we've been joined by Senator D'Amato, and I wanted to call on him for an opening statement. But, when I return, to plant in your mind, I want to ask some questions about the Congress and what you think our role ought to be in contributing to a more effective oversight.

Mr. Diefenderfer may be swept away by the positive comments made by our chairman as he recognized you. I fail to carry out what has been a committee standard procedure, which is to swear all of its witnesses.

So, if you would please stand and raise your right hand. And the affirmation which you are about to make will apply to that which you have said, at least since 2:50 this afternoon. [Laughter.]

And that which you will say in the future, at least until you are excused from this committee.

Please raise your right hand.

Do you swear that the testimony you are about to give is the truth, the whole truth and nothing but the truth, so help you God?

Mr. **Diefenderfer**. I do.

Senator **Graham**. Senator D'Amato.

OPENING REMARKS OF SENATOR D'AMATO

Senator **D'Amato**. Mr. Chairman, I have another subcommittee meeting, and I want to commend you for your work on looking into what we can and should be doing about oversight, particularly of the essential programs. It should be based upon fairness in the administration, fairness among those in need.

And so I would like to put this statement into the record in its entirety. I commend you for the hearings and I hope that they will result in our working with the administration and Secretary Kemp in taking steps to see to it that the needed reforms are put into place; I hope that we can continue with these programs and not use the failures of the past as an excuse to do away with programs that are absolutely essential.

I think, had we had a system whereby these programs were administered on the basis of genuine need and fairness, we would not have had a situation where political panderers came in representing clients and made awards based on who you know, as opposed to the merit of the award.

That's a shame. I'm particularly annoyed because I'm quite candid with you, Mr. Chairman, what that has done for those

Members of the Congress who have been advocates where there are needs has put many of us, Senator, in a position where we have to attempt to distinguish our activities, activities that a Congressman and Senator should be undertaking on behalf of constituents, from those with high-priced lobbyists, et cetera.

And I don't denigrate lobbyists, but I certainly do denigrate the awards that are made simply on the basis of who you are rather than the demonstrated need for them.

So I, too, share in this concern. And I believe it's becoming very difficult. When I see letters brought before the public in the media, where there have been some of our colleagues who have legitimately inquired on behalf of programs and projects in their district, tarnished with the same brush of those who've come in with large fees, or who are politically connected.

There is a great distinction. And I think it's unfair to Congressmen and Senators—I thought that was our job, to be advocates on behalf of legitimate needs for our constituents. And I certainly make no apology for that.

And that's why I would hope that we would establish this program based upon need and if we're going to succumb to the pressure of the media, that is, that Congressmen and Senators cannot nor should they make inquiry, even on behalf of those constituents who have been supporters of them, then I think we are going to establish a rather dangerous precedent. We're going to have the bureaucrats—who in some cases are never responsive to anyone except their own whims and caprices, when they decide to move, as the sole body of authority.

I don't think that's necessarily good. I think people should have a right to come to their Congressmen, their Senators and ask them to make inquiry, whether to its applications or to programs or to the manner in which they're being administered, or to see that they get a fair hearing.

And I think that's quite a different ball game from the kind of thing that has been testified to, that has shocked people, where we see incredible fees being given for phone calls or for calling something to someone's attention.

And I think what I've seen at least when I see Senator So-and-So, whose name is bandied about because he may have sent a letter on behalf of a program or a project or a constituent in his district. If we're going to begin to equate the abuses with that kind of legitimate congressional and senatorial inquiry, it's going to be a rather sad day.

And I think it's become too much and too easy to make that a target and smear it with the same brush.

So I'm delighted that you're undertaking this work and I'm pledged to work with you in this endeavor, Mr. Chairman.

I thank you.

[The complete prepared statement of Senator D'Amato follows:]

PREPARED STATEMENT OF SENATOR D'AMATO

Mr. Chairman, I am pleased to continue our hearings into the Moderate Rehabilitation Program. Today's hearing will focus on the oversight role of OMB and the White House. I look forward to working with you, Mr. Chairman, and the current administration to insure that housing dollars reach those who are most in need.

I must commend President Bush and this administration for responding quickly to management and programmatic deficiencies at HUD. Secretary Kemp has introduced a Reform Proposal to create a more efficient environment at the Department. This proposal has reached the final stages of drafting and is expected to be introduced in the House and Senate this week. I look forward to working with the Banking Committee leadership and the administration to advance these reforms.

OMB has also made a number of changes to refocus attention on Federal agency management. In recent testimony before the Senate Government Affairs Committee, Richard Darman stated his intention to push and reenergize the "M" in OMB. He has asked for more staff to focus on management. The OMB received additional funds for this purpose in this year's Appropriations' bill. In addition, he completely concurs with the May GAO report that there is a need for better integration of management and budget functions. This has been a key problem with the Moderate Rehabilitation Program and housing programs in general.

Richard Darman has also stated that HUD does not appear to be the Federal agency with the worst management problems. Its management problems seem to lie somewhere in the middle of the pack. This comment underscores how important it is for Congress to perform a regular, comprehensive assessment of all federal dollars.

I continue to welcome oversight efforts as they relate to housing programs, and I look forward to working with this administration to ensure that Federal dollars are used efficiently for those who truly need affordable housing.

Thank you, Mr. Chairman.

Senator GRAHAM. Thank you.

Senator D'AMATO. I didn't mean initially to make such an expansive statement. But, sometimes, my blood boils at the manner in which I see the activities of those of us in the Senate and the Congress lumped with those activities that were clearly inappropriate. I don't blame someone from the outside that comes in and is encouraged to undertake this. But, certainly, those who are administering the programs have got to make the distinction and be able to say to even friends:

I'm sorry. This program, this project doesn't fly.

And that's where I think that we had some problems.

Senator GRAHAM. Thank you, Senator.

Senator Riegle.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. Thank you, Mr. Chairman.

I want to just say, Mr. Diefenderfer, I appreciate the candor in acknowledging the major problems that existed in the past, that you've been very frank to acknowledge under the heading of collective oversight having failed.

When I look at the list of programs in HUD, however, I think it's important to note that while much of the attention is on what's called the Mod Rehab Program, where we seem to see the most pervasive pattern of abuse and favoritism, that, in addition to that, the costs there appear to be up into the hundreds of millions of dollars.

But, in the coinsurance program, we're finding that Federal losses so far have been $1 billion in that area, with the prospect of losing perhaps another billion dollars.

In the FHA area, which insures $277 billion worth of mortgages overall, it's been a frequent target of investigations, and it's now thought that losses may run there as high as $6 billion. Obviously, those are very high estimates, but there are people who think they could run that high.

Then there's the retirement service centers, started by Secretary Pierce, intended to house low-income senior citizens, but much of the money went on to finance luxury projects instead. And of the $101.2 billion in mortgages insured, apparently 29 percent are now in default. The cost there runs at about $119 million as presently estimated.

Then there are at least two other Sale of Foreclosed Properties, where we know at least $20 million was embezzled; maybe much higher in Title X, Land Development Mortgage Fund. Loan defaults there cost $90 million; it may go higher.

Probably other programs as well. So I think it's important to note that the pattern seems to have been quite pervasive, quite widespread. And I'm obviously interested in having the opportunity to inquire to the next witnesses, who were in relevant duty stations at the time this was happening, as to, you know, their sense for how this could come about.

But, I assume that, from the point of view today, working with Secretary Kemp, who has made it a top priority to clean up the messes he, himself, refers to it, that you are scrubbing down all these programs, I assume.

Do you have enough personnel to do that?

Mr. **DIEFENDERFER**. Presently, we do not, sir. If our appropriations bill is enacted at the level it is presently in conference, we will have enough to do a credible job.

The **CHAIRMAN**. I'd like to indicate to you that we expect you to come to this committee if you find, in light of the pattern of past abuse, if you don't have sufficient resources internally—management people and others—to fully carry out your oversight, I would expect you to take an affirmative step and convey a message to this committee indicating that you are short of the resources you need.

It will not be acceptable at some later point to come back and say, sorry, we missed it again because we just didn't have the people we need.

We expect you to make sure you've got the people you need and that they're doing the job.

And so, if there's any problem in that area, feel yourself under an obligation to tell us and we'll do all we can to get you the resources that you feel you need.

Mr. **DIEFENDERFER**. I consider that a favor extended and we will take advantage of it if and when we need it, sir.

The **CHAIRMAN**. Very good.

That's all for me at this point, Mr. Chairman.

Senator **GRAHAM**. Thank you very much, Mr. Chairman.

To pursue the question that you concluded with, you said in your opening statement that the failure of oversight was broadly distributed. I agree with that.

From your current position, as well as your extensive experience with the Congress previously, what do you think this committee should have as its monitoring devices, techniques, data in order to fulfill our responsibility for oversight?

RECOMMENDATIONS FOR OVERSIGHT

Mr. **Diefenderfer**. I'm glad you put me under oath, sir, because I'm going to tell you what I have recommended in the past. I have been a chief counsel of two committees in the Senate, and this is not a partisan statement because I was chief counsel for the Republican side.

But, whether it's Republicans or Democrats, I was not able to interest very many members in oversight. If I were the chairman of a full committee and had the power, which I think a chairman of a full committee may, I would insist that for every department under my jurisdiction, that the subcommittee chairmen with jurisdictional responsibilities for those departments conduct detailed hearings into every IG report issued, into every Federal Manager's Financial Integrity Act Report, which is issued once a year. That would be three reports.

I would insist that they go to the t's, the i's and the periods of those reports and conduct detailed hearings. Bring the departments, agencies, administrations before them and ask them:

Is the IG right? If he is right, what are you doing about it?

And do this on a regular basis. I think it's the responsibility of the chairman of the committee to do so.

Additionally, the other step that I would take if I were a chairman and/or a member of the committee is to review the budgets of all the departments, administrations or agencies that I authorized. And not only what I authorized but what is appropriated, ensure that a credible amount of money that is allocated in the appropriations and authorizations goes to the management functions of those departments.

That does not happen now and has not happened in the past. We're trying to redirect that. Management was not a sexy issue; it was ignored. They would plead for funds. They would * * * with the various people responsible. Generally, ultimately, it's a political decision. And they would have no or very little success in most instances.

Those are three steps. There are probably many many more, but you can't ask too much of the committee and Members elected to the Senate have very, very broad responsibilities.

But I think these are three steps that could be instituted, would certainly take some time but not an overwhelming amount of time, that would institute a discipline on the system from Congress that would make the managers' jobs in the departments, agencies, administrations much easier, because you have elevated their job to a level that you consider by your attention to be important. Therefore, their bosses will consider it to be important.

The **Chairman**. Mr. Chairman, would you yield at that point?

I expect that one of the results of the work of this newly formed investigative subcommittee will be to make formal recommendations at the end of the work process that will cover a variety of things, including these kinds of new procedural safeguards and steps that we might take here, both legislatively and in terms of just the normal oversight activities that we should set up and execute.

In that respect, I'd like to just draw on another experience that I think is relevant to this. And, occasionally, we have these cross-connecting experiences, that I think they're worth taking a minute to mention.

I had the occasion to serve as the newly appointed chairman of the Science and Space Subcommittee on the Commerce Committee a few years back just weeks before the *Challenger* Shuttle exploded. And we had a clear catastrophic accident on an unprecedented scale—loss of life, loss of the spacecraft and a tremendous blow to the country.

And as we began to go back through that problem, which took a period of many months and tens of thousands of hours of effort by many people, including the Rogers Commission and so forth.

But, one of the things that we found was that, in the rush to go forward and carry out program mandates and so forth, that the things that would relate to safety and running down stubborn problems that were known about and were there and inherently dangerous under certain conditions to safe use of the spacecraft at that time really did not get the attention and the care that they ought to have gotten.

And part of the review was to take and very substantially beef up the kind of safety oversight resources and the monitoring resources to try to catch those things that could really set off a catastrophic systems failure.

And as a result, when we fixed the O-rings, which turned out to be the principal source of that explosion and devastating loss of life and of the spacecraft itself, we undertook to fix every other error that we could find, or any other engineering problem or problem in the system that had been identified but had not really come under the kind of scrutiny to be fixed that perhaps it should have.

So, when we fixed the O-ring, we fixed a lot of other things as well that properly we should have.

But, the point of my digressing for this is simply to say that it was really only after the fact, after this terrible occurrence, that the careful look was done on the points that might have caught things early in the game and didn't.

And it seems to me that I'm hearing this witness say today that, conceding that there ought to have been managerial safeguards along the way within OMB and in other locations as well, it ought to have prevented some of these kinds of abuses from taking place—should have foreseen them, should have stopped them and should have blown the whistle on them—and, in fact, they were not there because those were not seen as high-priority items.

So, hopefully out of the recommendations that are developed, we can decide the part in that that we here must play. And I'm determined to see that this committee play it in the future.

I thank the chairman.

Senator **Graham**. Thank you, Mr. Chairman.

You've mentioned some of the areas that you believe that the Congress should focus on. Are there any data systems that you monitor or are assured that others are monitoring in order to determine the health of an individual agency—and we'll use HUD as an example—that at a higher level of aggregation, you believe it might be appropriate for Congress to also monitor?

What's the thermometer that you inject into an agency to get an immediate readout of the health of that agency?

TOOLS FOR MONITORING THE HEALTH OF AN AGENCY

Mr. **Diefenderfer.** Well, unfortunately, I don't think the level of the technology is at the level of the thermometer. It's more the hand to the brow that maybe your mother did to establish whether or not you had a fever. So it's not a perfect instrument.

We do have and are promoting several different accounting systems, checks and balances within existing systems. We are trying to establish in each department—I think Secretary Kemp has asked for a Chief Financial Officer, for somebody who looks full-time over the financial system.

These are the types of things that we have in some places and are trying to establish in others.

As to whether they would be valuable tools to the Congress, I guess they might be. But, I have one warning. At least, I think it's a warning in terms of what you set out to do.

The good management and attention to good management has to become a habit, like brushing your teeth in the morning. If you make it much more elaborate than that, what I think will happen is, over time, when there's a reason for it—whether the Challenger has exploded or there's a HUD scandal—it will be * * * to do this for a while. But, as time passes, it won't—the immediacy will deteriorate.

So I think the committees can set one or two or three goals for themselves—we set more for ourselves because we're in the management business full time. But, one or two or three goals for the committees, and that they do them like brushing their teeth every day.

That's enough. That will give the extra pressure. An example I would use to illustrate the nature of the problems we're dealing with is this book we have put together. This is an interesting book—it goes from the fifties through the eighties, and the nature of the scandals, the nature of the problem are the same in the fifties as they are in the eighties—through Democrat administrations, Republican administrations, Democratic Congresses, Republican Congresses.

The problems haven't changed. We haven't developed a system among ourselves that becomes a habit. If we try to force a too elaborate a system, I think people ignore it. It gets too cumbersome. It gets to where you check boxes and size off.

So I would welcome the Congress to look at any of the data systems we use to collect—the CFO legislation, where we have some chief financial officers in place in some departments now.

But I come back to the three things I recommended. If the committees make those the targets and everybody does them regularly, I think that will put a lot of discipline on us, the administration, knowing that will put a lot of discipline on us, the administration, knowing that you are looking over our shoulder and you're looking at the basic documents that acknowledge our shortcomings.

Senator **Graham.** If the Congress had been following your advice and focused on those three items, based on your review of the recent history of HUD, what do you think Congress could have determined from those documents? And what would closer questioning of the Department have elicited?

Mr. **Diefenderfer**. Well, if Congress had been doing this since, say, 1975, or we at OMB had been doing our job since 1975, I think we could have prevented, not unearthed the problem. I think these problems are, in a sense, like pools of stagnant water. If there's nobody in there stirring it up, getting the air back into it, the bacteria congregate and you have results that are unpleasant.

So, first of all, I think, if we had been doing our job and if Congress had been doing their job, we wouldn't have had this occur.

But, assuming the oversight by OMB or the Congress in earnest, started in, say, 1984 or 1985, you would have seen an IG report that said that we've got problems here. You would have seen OMB reports, to give credit to the OMB examiners on the policy side, saying: Don't continue this program. It has many faults.

Now, they didn't know one of the faults was corruption, if that's the problem, or fraud. They didn't say that. But, they did say "awful lot of discretion," "awful lot of money moving around here." That's a recipe for problems in programs without a lot of discipline.

Senator **Graham**. But, wasn't the administration at this same time asking for additional discretion? For instance, the elimination of the Fair Share Program, which had, from the testimony we received, operated well and had tended to push decisions down to the local level where they were made based on more objective standards than occurred after the Fair Share Program was disbanded? And those same decisions were now moved up to Washington?

Isn't that an inconsistency? If OMB was raising problems but at the same time advocating a management change that at least exacerbated?

Mr. **Diefenderfer**. I am not aware of the particular instance that you talk about. But I will give the point that that did occur and, yes, it is an inconsistency. OMB nor any other institution is a perfect institution. That would be, in my judgment, an example of perhaps a mistake.

I would make one additional comment though. And you mentioned that pushing the decisions further down, State and local level, where they know what the problems are and make better decisions.

LOW-INCOME HOUSING TAX CREDIT

Well, I helped make a decision once like that and have come to live to regret it. In the low-income housing tax credit, we ar the Senate Finance Committee were very concerned about the doubling up of the credits, the housing credits, including Section 8. We had it drawn very narrowly in our bill. We received a lot of—pressure is the wrong word—the well-intentioned advice from many people, including many members of this committee—well-intentioned in that they thought we were maybe cutting the credit too thin and you had to layer these other programs on top of it.

So, we allowed section 8 to be layered on with certain checks, certain release valves. One of the release valves is that the ultimate allocator of the low-income housing tax credit was to be the State.

And the State was supposed to look and say how can I best use these dollars? And, unfortunately, in many instances, we find out their judgment of how best to use the dollars is to give some people huge amounts of money. Section 8 on top of low-income housing credits.

That is not meant to be a definitive criticism of State or local activity. I don't feel that way. I just say that they are vulnerable to the same pressures, the same misjudgments and the same lack of oversight in some instances that we are at the Federal level.

Senator **Graham**. Well, I don't want—we may pursue this at a later time, but I'm concerned about the absence of a coherency to management. If the executive branch felt that low-income tax credits could be abused by excessive layerings, and certainly has been one of the clear findings of the hearings thus far, it was in the power of the executive branch to direct HUD to take those low-income tax credits into account when it set what were reasonable rent standards.

Instead of doing that, the testimony we've had is that it went exactly in the opposite direction, of loosening the standards for fair rent.

So, if the administration felt that the tax credits were drawn too loosely, it not only missed an opportunity within its power to control that, it enhanced the opportunities which were then rapaciously taken advantage of to abuse the system.

Mr. **Diefenderfer**. What I was speaking of, sir, I wasn't part of the administration at that point in time. I thought it was too loose as chief of staff of the Senate Finance Committee. I don't know what the administration's position at that point in time was on the layering of credits.

I do think that we obviously put it on much, much too thick, not only at the Federal level but at the state level.

Senator **Graham**. Mr. Diefenderfer, I appreciate very much your significant contribution to our understanding of the current situation in OMB and your assessment of the recent past.

Mr. **Diefenderfer**. Thank you very much, sir, for this opportunity.

Senator **Graham**. Thank you. And I'm certain that your statements, even after this hour, will be truthful. [Laughter.]

And to the best of your knowledge.

Thank you very much.

Mr. Richard Davis and Ms. Carol Crawford.

Mr. Davis and Ms. Crawford, if you would please stand and raise your right hand:

Do you swear that the testimony you are about to give is the truth, the whole truth and nothing but the truth, so help you God?

Mr. **Davis**. I do.

Ms. **Crawford**. I do.

Senator **Graham**. Thank you.

Mr. Richard Davis, former Associate Director for Cabinet Affairs, the White House.

Mr. Davis.

STATEMENT OF RICHARD DAVIS, FORMER ASSOCIATE DIRECTOR FOR CABINET AFFAIRS, THE WHITE HOUSE, WASHINGTON, DC

Mr. Davis. Thank you, Mr. Chairman, and members of the Senate Committee on Banking, Housing, and Urban Affairs.

As you requested, I appear before you today voluntarily to discuss my tenure at the Office of Cabinet Affairs in the White House and my dealings with the Department of Housing and Urban Development.

The period of time covered under your request includes my service at the White House beginning in August 1985 to March 1987. You should be aware that my White House records have not been available to me to review in connection with this testimony, but I'll do my best today to rely on my memory to address the issues being explored by your committee.

I believe it will assist the committee at this hearing to understand my role during the time I was at the White House.

As Associate Director of Cabinet Affairs, I served as the White House Policy Liaison with 12 Cabinet Departments and Agencies. They included Health and Human Services, Transportation Department, Education Department, Housing and Urban Development, Interior, and the sub-Cabinet agencies, including NASA, National Science Foundation, EPA, FEMA, Federal Maritime Commission, GSA and the National Transportation Safety Board.

During my tenure in Cabinet Affairs, there were two other individuals who were responsible for covering the remaining Cabinet and sub-Cabinet level agencies.

One other person in our office managed Cabinet events and meetings held at the White House. I mention these other individuals only as a way of demonstrating that, in Cabinet Affairs, we had a very small staff—four professionals with responsibility for liaison with all departments and agencies.

The function of Cabinet Affairs during this period was to serve as a conduit for the views of the various departments and agencies and other White House offices in preparation of position papers for the President and on policy issues, as well as routine liaison functions between the White House and the executive branch agencies.

Policy-making in the White House during my tenure was coordinated by the Secretary of Cabinet and the National Security Advisor and organized around three policy councils: the Domestic Policy Council, the Economic Policy Council and the National Security Council.

For our purposes today, two of these councils, the NSC and the EPC, are not relevant because HUD did not participate in these bodies.

The Domestic Policy Council was operated through the Secretary of Cabinet and was made up of those agencies that dealt with domestic, noneconomic issues. They included the Housing and Urban Development, Department of Education, Energy, Health and Human Services, Interior, Justice, along with the Offices of Management and Budget and the Council on Economic Advisors.

Representing each of these agencies was the Secretary of the Department or Agency Chief, or, if they were unavailable, their

Deputy. The Council had an Executive Director and three professional staff members.

Their responsibilities included formulation of policy papers for Council deliberations. Policy papers were routed through the Domestic Policy Council for ultimate decisionmaking by the President. My boss, the Secretary of Cabinet, Mr. Alfred H. Kingon, was responsible for both the Domestic Policy Council and the Office of Cabinet Affairs, those staffs I had mentioned to you earlier.

My role was not to make policy but rather to facilitate policymaking between Cabinet agencies and the White House. My job was to primarily serve as a two-way communication channel between the departments in the White House and vice-versa on these policy issues.

Mr. Chairman, the committee staff has informed me that you would like to address questions relating to my responsibilities with respect to HUD during my tenure at the White House.

I've completed my opening statement and will be happy to answer questions you may have on this topic.

[The complete prepared statement of Richard H. Davis follows:]

Statement of Richard H. Davis
to the Committee on Banking, Housing and Urban Affairs

October 19, 1989

Mr. Chairman and members of the Senate Committee on Banking, Housing and Urban Affairs, as you requested a week ago I appear before you today, voluntarily, to discuss my tenure at the Office of Cabinet Affairs in the White House and my dealings with the Department of Housing and Urban Development.

The period of time covered under your request includes my service at the White House beginning in August of 1985 to March of 1987. You should also be aware that my records at the White House have not been available for me to review, and therefore I must rely solely on my memory.

I believe it will assist the Committee in this hearing to understand my role during my time at the White House. As Associate Director of Cabinet Affairs, I served as the White House Policy Liaison with 12 cabinet departments and agencies. They included: Health and Human Services Department, Transportation Department, Education Department, Housing and Urban Development, Interior Department, and the subcabinet agencies including: NASA, the National Science Foundation, EPA, FEMA, Federal Maritime Commission, GSA, and the National Transportation Safety Board. Coinciding with my tenure in Cabinet Affairs there were two other individuals covering all other remaining cabinet and subcabinet level agencies. One other person in our office managed Cabinet events and meetings held at the White House. I mention these other individuals only as a way of demonstrating that in Cabinet Affairs we had a very small staff with responsibility for all departments and agencies in the executive branch.

It is important to understand the structure of policy decision making in the White House during this period in order to understand the role that the Office of Cabinet Affairs played. Our role was to serve as honest broker for the views of the various departments and agencies and other White House offices in the preparation of position papers for the President.

Policy making in the White House was coordinated by the Office of Policy Development and organized around three policy councils; the Domestic Policy Council, the Economic Policy Council and the National Security Council. For our purposes today, the National Security Council and the Economic Policy Council are not relevant because HUD did not participate in these bodies.

The Domestic Policy Council was operated through the Secretary of the Cabinet and made up of those agencies that dealt with domestic, non-economic issues. They include, the Department of Housing and Urban Development, Education, Energy, Health and Human Services, Interior and Justice along with the Office of Management and Budget and the Counsel of Economic Advisors. Representing the agencies were the secretary or agency chief, or if unavailable, their deputy. The council had an executive director and two or three professional staff members. Their responsibilities included formulation of policy papers for council deliberations. Policy papers were routed through the Domestic Policy Council for ultimate decision making by the President.

My boss, the Secretary of the Cabinet, Mr. Alfred Kingon, was responsible for both the Domestic Policy Council and the Office of Cabinet Affairs whose staffs I have mentioned to you earlier. My role was not to make policy but, to facilitate policy making between the cabinet agencies and the White House. My job was to serve as a two-way communication channel between the Departments and the White House and vice versa.

As I understand it your hearing is about the Department of Housing and Urban Development exclusively. It is important, however, for you to understand that I had responsibility for five cabinet agencies with less than 10% of my time spent on HUD related issues.

This completes my opening statement, I am now prepared to entertain your questions.

Senator **Graham**. Thank you very much, Mr. Davis.

Ms. Carol Crawford, former Associate Director for Economics and Government, Office at the Office of Management and Budget.

STATEMENT OF CAROL CRAWFORD, FORMER ASSOCIATE DIRECTOR FOR ECONOMICS AND GOVERNMENT, OFFICE OF MANAGEMENT AND BUDGET, WASHINGTON, DC

Ms. **Crawford**. Thank you, Senator, Mr. Chairman.

I'm happy to be here today to discuss the role of an OMB Associate Director and particularly in the context of your hearing concerning OMB oversight of the agency.

I will give you just a brief statement of my functions while at OMB to give you a sense of it, and then would be happy to address questions.

I served as Associate Director for Economics and Government at OMB from October 1985 to January 1989. In that position, I was responsible for the budgets of five Cabinet level departments, including the Justice Department, Treasury, Transportation, Commerce, and HUD. And, in addition, my portfolio included the SBA, virtually all of the regulatory commissions, and a series of smaller agencies. I won't list all of them.

The point of including the entire list is to show the breadth of an individual Associate Director's responsibility, and the portfolio at the Office of Management and Budget.

The responsibilities of an OMB Associate Director are to review agency budget submissions and to make recommendations on appropriate budget allocation and policy initiatives.

Subsequent to submission of the President's budget, the Associate Directors are also responsible for tracking the President's request in the appropriations process.

Similarly, Associate Directors assist in the development of administration policy in their substantive areas, from development of legislative initiatives through enactment of the President's proposals.

My deputies at OMB, and all the remainder of my staff, were career Federal employees, high professional, dedicated and hardworking individuals. Most staff were organized by branch and division. Within my area, the housing branch was located in the Housing, Treasury and Postal Division. It consisted of a branch chief and roughly five examiners. On occasion, as I recall, I may have had six examiners.

The housing branch was responsible for all HUD and FEMA and related agency budget analysis and development, budget implementation and appropriations tracking.

The housing branch also provided policy analysis and research on housing issues and generally served as a resource in the development of housing policy and the pursuit of the President's initiatives with the Congress.

Your letter of invitation stated that your hearing would focus on the oversight role of OMB. OMB performs many roles in the Federal structure, but to the best of my knowledge and experience during my term at OMB, OMB Associate Directors—and I will clarify that that is on the budget side, not on the management side, which Mr. Diefenderfer just addressed—we did not at that time have an oversight role with respect to the agencies whose budgets we handled.

OMB's responsibilities, at least, again, during my tenure, included budget and policy analysis, and development, and policy implementation. Policy implementation, specifically, the application of regulatory and statutory policy in specific cases. Specific grant decisions, for example, and the administration and, quote/unquote, "oversight of agency programs" were fully in the province of agency managers.

That is an overview of my role and the role in general of an associate director, the policy and budget side, Associate Director in Office of Management and Budget.

And I'd be happy to answer any questions that you have.

[The complete prepared statement of Carol T. Crawford follows:]

STATEMENT OF CAROL T. CRAWFORD
ASSISTANT ATTORNEY GENERAL FOR LEGISLATIVE AFFAIRS
U.S. DEPARTMENT OF JUSTICE

BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

OCTOBER 20, 1989

Mr. Chairman, Senators, I am happy to be here today to discuss the role of an OMB Associate Director.

I served as Associate Director for Economics and Government at the Office of Management and Budget from October, 1985 to January 1989. In that position, I was responsible for the budgets of five cabinet level departments: Department of Justice, Department of the Treasury, Department of Transportation, Department of Commerce, and Department of Housing and Urban Development. In addition, my portfolio included the Small Business Administration, the Interstate Commerce Commission, the Federal Trade Commission, the Securities and Exchange Commission, the Commodities Futures Trading Commission, the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Federal Communications Commission, the Federal Emergency Management Agency, the Federal Maritime Commission, the State Justice Institute, the Marine Mammal Commission, Appalachian Regional Commission, Corporation for Public Broadcasting, the District of Columbia, the Administrative Conference of the United States, the National Institute of Building Sciences, the Neighborhood Reinvestment Corporation and the Christopher Columbus Quincentenary Jubilee Commission.

The responsibilities of an OMB Associate Director is to review agency budget submissions and to make recommendations on appropriate budget allocations and policy initiatives. Subsequent to submission of the President's budget, Associate Directors are responsible for tracking the President's requests in the appropriations process. Similarly, Associate Directors assist in the development of Administration policy in their substantive areas, from development of legislative initiatives through enactment of the President's proposals.

My deputies and all other staff were career federal employees, highly professional, dedicated and hardworking individuals. Most staff are organized by branch and division. The Housing Branch was located in the Housing, Treasury and Postal Division and it consisted of a Branch Chief and five examiners. The Housing Branch was responsible for all HUD and FEMA and related agency budget analysis and development, budget implementation and appropriations tracking. The Housing Branch also provided policy analysis and research on housing issues and generally served as a resource in the development of housing policy and the pursuit of the President's initiatives in the Congress.

Your letter of invitation stated that your hearing would focus on the "oversight role" of OMB. OMB performs many roles in the federal structure but, to the best of my knowledge and experience, OMB Associate Directors do not have an oversight role with respect to the federal agencies whose budgets they handle. OMB responsibilities, at least during my tenure, included budget and policy analysis and development and budget implementation. Policy implementation and administration and "oversight" of agency programs were in the province of agency managers.

I would be happy to respond to any questions.

Senator **Graham**. Thank you very much, Ms. Crawford.

Mr. Davis, in your role as an Associate Director for Cabinet Affairs, you served, and your statement indicates, that you were the point of contact between the White House and various agencies, including HUD.

As you stated in your testimony before the House Government Operations Subcommittee, you had no involvement with specific HUD projects while at the White House.

Debra Dean has stated in a deposition that the White House was extensively involved in advocating funding for specific projects.

If you were not involved with specific projects, who on the White House staff was?

INVOLVEMENT OF WHITE HOUSE STAFF

Mr. **Davis**. Senator Graham, I was asked a similar question while I was testifying to the Employment and Housing Subcommittee in the House, and I'll have to give you a similar answer.

It was clear to us in Cabinet Affairs, and certainly to me in my role with HUD, that we had a standing policy at the White House, enunciated to me by the Chief of Staff and by my boss, Alfred H. Kingon. And they made it clear to us that, at no time, were we to involve ourselves in specific projects or the selection of specific projects in the course of the funding of these projects.

I'm not aware of any particular activity that Ms. Dean is speaking about, or which you characterized her talking about. I haven't seen her testimony. All I've had is the press reports, that I assume we've all seen.

And so I don't feel I really know to what context she is speaking. But I don't know, particularly in my experience at the White House, of specific instances in which people were out recommending projects, per se.

Senator **Graham**. So, to be specific, it's your testimony that you, in your position as Associate Director for Cabinet Affairs, were not involved in specific projects which were before HUD during the period of your service in that position?

Mr. **Davis**. That's correct, Senator.

Senator **Graham**. It is also your testimony that, as Associate Director for Cabinet Affairs, you were unaware of any other White House personnel being involved in specific projects before HUD? Is that correct?

Mr. **Davis**. Yes, sir.

Senator **Graham**. Would it have been likely that a member of the White House staff or other personnel associated with the White House would have had significant contact with HUD on specific projects without your knowledge?

Mr. **Davis**. I can't speak to specific projects. As I have spoken to both the staff here and to the Subcommittee on Employment and Housing before the House, it's not unusual that other people in the White House would talk to any other Cabinet agency. I believe, in my testimony to the House subcommittee, I mentioned that the White House in some respects is a mirror image of the Cabinet agency. It has an intergovernmental affairs office, a congressional affairs office. These people obviously are in contact with similar offices that exist in the various executive branch agencies in order to do their daily business in dealing with Governors, mayors, Congressmen and such.

So, I would speculate that certainly other people were involved in discussions with other Cabinet agencies. Whether it entailed discussions on specific instances of funding projects, I'm aware of none.

Senator GRAHAM. You mentioned the strictures under which you operated relative to contact with HUD on specific projects.

Were those directives peculiar to the Associate Director for Cabinet Affairs, or were they generally applicable to White House personnel?

Mr. DAVIS. I can pretty much speak for myself on that, but I would ensure they were definitely applicable to us. But I would assume they were also applicable to other offices in the White House.

Senator GRAHAM. So, if persons in the White House were, in fact, engaged in dealing with HUD on specific projects, they were in violation of their stated rules of procedure? Is that correct?

Mr. DAVIS. It certainly would be inconsistent with that rule that we worked under, yes, sir.

Senator GRAHAM. And, again, to re-ask the question:

You were not involved in any specific projects before HUD and you are unaware of any other White House personnel that were involved in specific projects before HUD?

Mr. DAVIS. Yes, I would have to say—and I assume, sir, from the onset, you are speaking as an advocate for specific projects. You know, I would have to make the difference in identifying any other specific projects as far as sending material over to these agencies is an exception to that, with making no value judgment as to whether it should be considered as a fundable project or otherwise.

Senator GRAHAM. Well, what was the most—in what project were you most involved without attempting to place a descriptive label as to whether that constituted advocacy or not?

Mr. DAVIS. Well, I think one of the things you would have to understand is partially—which I alluded to in my statement—the role of my job in Cabinet Affairs.

As a routine matter, on a daily basis, we were a clearinghouse for information that would come into the White House, that we would then send back out into the agencies. And that included letters and telephone calls requesting information on specific projects, programs, legislation—whatever came into the White House that would get routed to my office in the standard routing system that existed at the time.

It was not unusual for me to slap a bump sheet on correspondence that we had, which was a standard form that labeled a number on every one of the pieces of correspondence we had in each of the agencies, and send it to an agency for disposition.

Many times, the request was, "Could you respond with a letter?" "Could you respond with a phone call?" find out what they want to have. It varied on every piece of correspondence.

In most, if not all, cases, I rarely knew what would happen to that correspondence once it went to the agency.

I don't think I could adequately testify to the fact that in that stack of correspondence to HUD, there was never an illusion to a specific project. But, whether our office or myself ever advocated that project is the distinction I think I'm trying to make.

Senator **Graham**. Do you have any project that you think Ms. Dean might have had in mind when she stated that the White House was extensively involved in advocating funding for specific projects?

Mr. **Davis**. With respect to me, no, sir.

Senator **Graham**. With respect to anyone else?

Mr. **Davis**. No, sir, I have no knowledge.

Senator **Graham**. Senator Riegle?

The **Chairman**. Thank you, Mr. Chairman.

ACCESS TO RECORDS

Do I understand that you have or had not had access to your records in preparation?

Mr. **Davis**. It's standard policy, at least in Cabinet Affairs, that you turn over your records to the Librarian of the White House, which I did when I left. And I've not had access to those records before coming into any of these testimonies. I believe they may be in California and you can only get through them by written request to William French Smith, which I have not done.

The **Chairman**. But, do you have any reason to think you would not be able to have access to your records?

Mr. **Davis**. No, sir, I don't have any reason to believe I wouldn't. I think there's a considerable waiting period, although that's only a thing I've been told. I haven't really tried to exercise that.

The **Chairman**. But the point is then that you're relying essentially on your memory without having an opportunity to review your records, which are in files but which you presumably could have access to if there were some extraordinary need for that?

Mr. **Davis**. Yes, sir.

The **Chairman**. Is that right?

Mr. **Davis**. Yes, sir.

The **Chairman**. Now, you indicate that in terms of—there was a lot of paper that went through you in a lot of different directions—not just to HUD, but to other areas as well. Some of it to HUD. And I take it some of it on projects. Is that right?

Mr. **Davis**. I would speculate that some of it had to do with projects, yes, sir. I can't recall specific instances of a project that someone might have written in about, but I would think there would be.

The **Chairman**. Now, would it likely, I mean, you know, we all have a hard time trying to reconstruct events in the past because these are busy jobs and there's a ton of material that comes through.

But, if you had seen anything, for example, that was coming from a notable, like a James Watt or somebody like that, would that be the kind of thing that would tend to stick in your memory? Or would that have come and gone like the rest and not be in your present memory?

Mr. Davis. No, sir, I would say that I would have followed the same process. I don't recall any specific individual that might have written in on a project. And I don't think it would have differed as to how we'd handle it.

So, no, I think the route would have been the same. And my recollection of that wasn't much. This was a sort of daily routine that virtually was handled by the secretaries. And my role on that was to just designate which agency needed to be receiving that piece of correspondence. We never really dealt with the substance of the correspondence. We, frankly, didn't have time.

The Chairman. Well, the reason, as you know, we ask is you're trying to also reconstruct what happened here, is that there were a lot of people trying to play an inside game and line up these contracts which were offered the attractiveness of very substantial money benefits to them if they could do it.

And so our sense is, from what we've been able to put together, is that they came through a lot of avenues. They, in a sense, used every avenue they could. And we're interested in trying to make sure that we understand what may or may not have come through your avenue.

Did you also get phone calls in addition to written correspondence? Your reference is essentially to pieces of paper. Were there phone calls that would come in that would be reduced to writing and then become pieces of paper?

Mr. Davis. Yes, sir, I would assume that that was the case. We would normally take in a considerable amount of telephone traffic on all kinds of various topics. In many cases, from other offices within the White House. But, yes, from outside, too.

And we would have boiled those down into specific request to agencies and fired them off just like it would have been a piece of correspondence.

The Chairman. So, is it fair to say that it would have been normal for you to get a certain number of phone calls on specific items from individuals outside that you would receive? You would presumably identify who the person was? Wasn't a crank call, or what have you?

And then you'd make a note on it and off it would go? Is that how it would work?

Mr. Davis. Well, routinely, if we're still speaking about these specific projects, we would try and advocate whoever was calling, especially if we had a dialog with them, to go to the agency. I mean, part of the standing rule that we talked about earlier, which was not to advocate specific projects, was to also get people to go back to the agency, to not use the White House as the court of last decree.

And, frankly, that was a very practical exercise for us because we simply didn't have time to deal with all these various requests. And until an appeal on some specific policy request had to get brought into our office, we dealt with that the same way, on both policy matters and on these, you know, cats and dogs, if you will, on requests that came in that really didn't belong in our office.

The Chairman. How would it be though that someone would just call you? I mean, how would somebody get on a list to be able to know you were the person to call, or that you would know they're a call you want to take? I mean, how would you screen out these calls? Or decide, you know, who was calling and what their relevance was and why you would even take their call?

Mr. DAVIS. Well, we had a lot of calls come in, as I mentioned earlier, and we would have a standing rule technically within the office that we would try—our secretaries would try and garner as much information from them as they possibly could.

And from that, we would categorize who in the office would return the call. Many of these were blind calls into the office from the outside.

The CHAIRMAN. Like from whom? I mean, who would constitute a typical blind caller? I don't ask you to recall a name, but I mean classes of blind calls.

Mr. DAVIS. Something that was not unusual for us was to get calls from State officials. Someone who had a particular program problem with an agency who would just assume they would get a call into the office or call into the White House and you'd get routed to our office.

Another typical call would be to anybody who knew what Cabinet Affairs was about, or had worked with Cabinet Affairs in the past. You know, would call our office, looking for information or for guidance on how to dispose of some project.

I think it's important at this point to sort of digress a minute and make sure you understand as well as the committee that our function in Cabinet Affairs was a policy function; 99 percent of the time we spent in dealing with policy issues that were before the President.

And the outgoing traffic on our behalf was in that same precentage. I would daresay that even HUD as an agency in my responsibilities inside Cabinet Affairs was less than 10 percent of my policy traffic.

So, when you boil down the kind of things you're talking about, which are outside the policy responsibilities that we had, which were even less than 10 percent, we're talking a very small number of calls, letters or traffic that would deal directly with HUD on these kinds of instances over the two years that I was there.

DEBORAH GORE DEAN

The CHAIRMAN. I want to review something else. Just did you have working contact of any sort with Debra Dean?

Mr. DAVIS. Yes, sir. On a regular basis.

The CHAIRMAN. What was the nature of the working contact?

Mr. DAVIS. Telephone calls and written correspondence on a daily basis that dealt with a host of issues. They include the Secretary's schedule on a daily basis, any kind of press reports that dealt with HUD or the programs at HUD, any kind of announcements that HUD may be making that would impact the press or the ongoing activity of the White House that day or that week.

The CHAIRMAN. You talked to her how often, would you say? I mean, you say daily.

Mr. DAVIS. I have to speculate daily. Once a day.

The CHAIRMAN. Once a day.

Mr. DAVIS. Maybe a week would go by, I'd never talk to her.

The **Chairman**. Yes.

Mr. **Davis**. Maybe we'd be active on a certain front and I'd talk to her three or four times a day.

The **Chairman**. I see.

Mr. **Davis**. It would be that kind of pace.

The **Chairman**. And how many Cabinet agencies were within your general purview?

Mr. **Davis**. I had six Cabinet agencies and eight subcabinet agencies.

The **Chairman**. And would the level of frequency with her be the same as it was with dozens and dozens of other people?

Mr. **Davis**. I would say, within the Cabinet agencies I dealt with, the level of frequency with her was less than the other Cabinet agencies I dealt with.

The **Chairman**. And in terms of whether or not you and she would ever discuss projects, specific projects?

Mr. **Davis**. Not as a matter of course, no, sir.

The **Chairman**. Well, how about not as a matter of course then? I mean, did you ever discuss——

Mr. **Davis**. As my testimony reflects earlier, I can't recall an instance where I advocated a particular project to Ms. Dean.

The **Chairman**. Well, let me ask you this. You know, from what we can gather, the indications are that there was a lot of political involvement and influence, people who were close to the administration, helped the administration, felt that their claims ought to get a little more attention, or more than others, and so forth.

So there seemed to be a lot of political sensitivity that attached to these things. And it's not terribly surprising that that would be so. The question is what's the degree and did it become a pervasive pattern? Did it tilt the final decisions?

Were you getting political phone calls from people? Were you hearing from people who were political hitters, or had political influence, that were trying to use the White House route—maybe they were using other routes as well, but they may have been using all the routes they could find.

Were there any instances, or were there instances where people were using their political standing, their political influence to get you to move their piece of paper, move the request through, even if you didn't add a comment to it, to speed things up for them?

Mr. **Davis**. Mr. Chairman, I'd have to say that in a generic sense, in a general sense, we got calls from political people. We got calls from Governors, from Congressmen, from Senators, from people in the political community, if that's a term we can use, and we gave them the same answer that I mentioned earlier, is that:

If you've got a beef or you've got a particular interest with an agency, you've got to go to that agency. You can't use the White House——

The **Chairman**. How about——

Mr. **Davis**. This is what we were saying.

The **Chairman**. Yes. How about lobbyists?

Mr. **Davis**. Same with them.

The **Chairman**. Well, I know, but I would expect you to get calls from public officials. You're a public official, they're public officials, and so that kind of traffic is going to go on.

I'm more concerned about the nonpublic officials that you were hearing from, people who are lobbyists who had a private interest that they were peddling rather than being in the public interest loop.

Mr. DAVIS. Yes.

The CHAIRMAN. I take it that you were getting calls like that. And were they essentially people who had good, strong political connections? I mean, I would assume a lot of them were. I mean, how else do you screen the calls?

Mr. DAVIS. Well, I wouldn't say that I only returned the calls of people who had good, strong political credentials. I got calls from lobbyists on, you know, any mumber of different issues. And, yes, we did respond to those calls in the sense of what we're talking about, yes, sir.

The CHAIRMAN. My time is up. I will come back to Ms. Crawford a little bit later.

Senator GRAHAM. Thank you, Mr. Chairman.

Ms. Crawford, in your statement, you describe your position as Associate Director for Economics and Government in OMB, and you state that your responsibilities were to review agency budget submissions and make recommendations on appropriate budget allocations and policy initiatives.

Is that correct?

Ms. CRAWFORD. Correct.

Senator GRAHAM. One of those initiatives which was recommended to the Congress and finally adopted in the mid-1980's was a provision which appeared in the appropriations bill eliminating the Fair Share distribution of Mod Rehab funds.

Were you involved in the policy development that led to the administration's recommendation to Congress to adopt such a change of position?

Ms. CRAWFORD. I think that must have predated me, Senator. I don't have a recollection of the Fair Share debate. Now, I also have to state the caveat again—that is why I'm emphasizing the breadth of the agencies and the policy areas that I was responsible for—there were many, many issues that went by very, very quickly. And I'm sure there are many that I was involved in that I signed off on that I simply don't recall.

I also don't have my records. So my best answer is I believe, if it was in the mid-eighties, it probably predated me. I went to OMB in October 1985.

Senator GRAHAM. Do you have any recollection subsequent to the elimination of the Fair Share Distribution Program of OMB's carrying out its policy analysis responsibilities relative to the impact that that change was having on the programs?

Ms. CRAWFORD. I don't have any specific recollection. To the best of my recollection, and this is very fuzzy, so I wouldn't want you to draw any firm conclusions from it, the best of my recollection was that Fair Share was a policy, an allocation policy, dependent upon having a large enough aggregate program size so that it was feasible to divide up programs, be it vouchers or Mod Rehab units or whatever.

If there were too few units to make it feasible to allocate based upon essentially a formula, then the program would convert and be handled as a discretionary program.

But I'm very uncomfortable discussing that, anything about the Fair Share Program, in a policy or an operational context because I honestly don't—I'm not sufficiently familiar with it. I have a very, very unclear recollection. I feel I have no specific knowledge of that at all.

Senator GRAHAM. Would it normally have been the responsibility of your office to have done post-adoption evaluation of the impact of policy initiatives or changes?

Ms. CRAWFORD. Once the policy—my office was involved, the Associate Directors' Offices, in general, are involved, I would say, on two or perhaps three levels. One is development of the statutory policy, the statutory initiative that is communicated to Congress through the budget message or the legislative message or in separate legislation that is sent up.

In some cases, the OMB analytical staff would develop the policy initiatives. In other cases, the initiatives would be developed by the agencies and sent through OMB for clearance among other agencies in the clearance process.

So that is one level. A second level in which OMB is involved and my staff, the budget policy staff would be involved, would be after a statutory program has been enacted and there is a need for regulatory implementation, so that the agency develops regulations to implement the program. In that case, the regulations come to OMB and are referred to OIRA, the Office of Information and Regulatory Affairs, which has responsibility for clearing regulations.

In many cases—I won't say all cases, but in many cases—the regulatory staff would work in conjunction with the policy staff, the policy and budget staff, to make sure, for example, that the proposed regulations reflected the Administration's policy, that they reflected the intent of Congress, that they didn't assume any new budgetary initiatives that might not be forthcoming. A whole range of cross-cutting issues would exist between those two staffs.

The regulatory staff would have the primary responsibility. But the budget staff, for example for housing regulations, the housing branch, would be consulted, in effect. They'd act as consultants in development of the regulations.

And then the third possibility—and this was very severely limited because of the size of our staff. OMB is a very small staff, as I indicated. The housing branch consisted of five budget examiners. In the course of a year during the off-budget season in the spring, we would undertake separate evaluations of various programs, either with a view toward developing new initiatives or with a view toward tightening up programs where we felt that there were some policy problems, to try to find new ways to solve problems.

So I would say that they would be the three levels at which we would become involved.

INTERNAL REVIEW MECHANISMS

Senator GRAHAM. Did you take advantage of some of the internal review mechanisms, such as the inspector general's reports?

Ms. **Crawford**. I virtually never saw inspector general's reports. And again, simply, for me, it was more a function of time. Also a function of the fact that—and I think Bill Diefenderfer's testimony addressed this—the kind of issues that the IG's would address would be generally management issues. And the management side of OMB really had responsibility for addressing those issues and doing followup on IG reports.

In some cases, IG reports were brought to my attention by my staff on a variety of issues. Where it was an issue or a program that we were particularly focused on and we had some policy concerns or any kind of problem that we might see with the program. If there were an IG report, the staff would usually bring it to my attention, so that I would be aware that an IG has looked at it, has come up perhaps with ideas that we hadn't come up with.

Similarly, with GAO reports. But, we did not routinely—my staff didn't—review them. The other side of OMB, I think, would be more involved in that. I just can't speak for what the process was on the management side. On the budget side, we did not systematically utilize these reports.

Senator **Graham**. During your tenure in this position, were you or any other members of your staff ever alerted to the problems in the section 8 Moderate Rehab Program or in the coinsurance program or in other programs under the responsibility of HUD?

Ms. **Crawford**. Let me answer that in two ways. One, my staff might well have been aware of a variety of problems that they didn't bring to me. OMB budget staff operates as a pyramid. And the individual, the examiners—examiner/analysts—take in a great deal more information than is ever kicked upstairs to the branch chiefs or to the Deputy Associate Directors or to the Associate Director; again, by necessity. I think that's a normal staff operation.

So there may well have been more information that was brought to their attention. If there were problems, they would generally be raised, raised to me. Of course, I don't have knowledge of things that weren't raised to me. Clearly, if they became aware of problems that were considered by them to be serious problems, they had an obligation to raise them to me or the other Associate Directors. And I think they did so.

I will reiterate that it is a highly professional career staff, very dedicated, very focused on making programs work in a cost-effective way consistent with the intent of Congress and the wishes of the President.

To go to your specific question about Mod Rehab, yes, in fact, we were aware or problems in the Mod Rehab Program. We had proposed, I believe, in each of the 4 budget years that I had responsibility for the HUD budget—my recollection is that we proposed zeroing that program in each of the 4 years.

And, again, don't hold me to that, but that's my recollection, because analytically it was not viewed as a cost-effective program. There were other rehabilitation programs that we felt, that the analysts felt, were far more cost-effective. Congress disagreed with us and continued to fund the section 8 Mod Rehab Program. Let me answer that ~~in~~ a second part. And that is, we were aware of policy analytical problems with Mod Rehab. We were not aware—I was not aware—of any problem with respect to the way the program was being implemented, in other words, if grants were not being made in a responsible way or a way that comported with the intent of Congress.

So on that level, I certainly had no knowledge of, and I doubt that my staff did. It would not be the kind of information that they would have access to.

Let me stop there.

Senator **Graham**. My time is up. I'm going to turn to the chairman. But, when my time returns, I'm going to probe that somewhat more deeply. It's difficult for me to understand how an agency which looks at such minutia could have systemically missed such a massive fraud as was occurring within HUD.

Mr. Chairman.

The **Chairman**. Well, Mr. Chairman, along that line, that wasn't the only one that was sliding by and not being observed at the time. Apparently, you also had responsibility for the Federal Home Loan Bank Board in your jurisdiction.

Ms. **Crawford**. That's correct.

The **Chairman**. And that was even a bigger disaster that was taking place. And insofar as I know, I don't recall any whistle-blowing going on that I remember where the administration was coming forward and saying, Hey, we've really got a disaster on our hands here and let's do something about it.

In fact, I remember the reverse, that things were—we kept getting the sort of A-OK signals until one administration was over and then Bush came in and, bang, we had a major package put upon the table.

I don't say that to try to stick the responsibility for that on you, but when I look down the list, you did, in fact, have a very important portfolio. The SEC, Commodities Futures Trading Commission, but certainly the Federal Home Loan Bank Board and the HUD oversight turned out to be really the two looming disaster areas. And somehow, you know, they seemed to have been able to slide right on by.

Ms. **Crawford**. I don't think I could concur that they slid by.

The **Chairman**. Well, I don't want to be unfair. You tell me your view of it.

FEDERAL HOME LOAN BANK BOARD

Ms. **Crawford**. No, and I appreciate your raising the Home Loan Bank Board because this committee of course has been deeply involved in that issue.

One of the first issues to arise and come to my attention as a severe problem in the offing—this was in the fall of 1985—was the Federal Home Loan Bank Board situation.

We, as I recall, were in the process of trying to raise some concern on the part of Congress, trying——

The **Chairman**. How about the President? Did you ever talk to the President about it?

Ms. **Crawford**. Absolutely.

The **Chairman**. What did he say?

Ms. **Crawford**. Everyone was concerned. We thought——

The **Chairman**. No, I mean did you talk to the President.

Ms. CRAWFORD. Did I personally? No.

The CHAIRMAN. Did your boss talk to the President about it?

Ms. CRAWFORD. Yes, there was a substantial briefing.

The CHAIRMAN. On the nature of the problem in the savings and loan system?

Ms. CRAWFORD. All sorts of problems, yes. There were a variety of options that were pursued; as you recall, we sought recapitalization 2 years before Congress moved on recapitalization.

I think we were far ahead of the Congress in recognizing that there was a very serious problem coming and that it needed to be addressed.

The CHAIRMAN. We would expect you to be. I mean, you know, the Office of Management and Budget ought to be the first place where the trip wire goes off.

Ms. CRAWFORD. Let me share with you another, and I think I've—I know I've spoken with other members of your committee about this problem.

There was an ironic situation and that's why I welcome the opportunity to address this with you and Senator Graham.

When I went to OMB in the fall of 1985, Chairman Gray was Chairman, at the time.

The CHAIRMAN. Right.

Ms. CRAWFORD. It was very quickly apparent to me that OMB did not have the kind of oversight—I use the word carefully, but I'm not sure it's, frankly, the right word. We did not have the kind of oversight control—and I'm not sure they're the right words—that we had with respect to other agencies.

We did not have the same tools with respect to the Federal Home Loan Bank Board that we had for other agenices. However, the Home Loan Bank Board and the Chairman and others didn't want any OMB or any other agency—oversight agency—looking over its shoulders. In spite of the fact that we had virtually no control over the agency and they were virtually a free spirit—we had virtually no policy, staffing, budgetary, any kind of control over them—they felt free, and I'm told that Ed Gray still feels free—to blame OMB for all the Board's problems, for example, that OMB refused him staff or budget or whatever.

I will say again—and I've put this on the record with your committee and with the House Banking Committee every time Mr. Gray has testified to the contrary, blaming OMB for failure to give him staff—I have followed with a letter that seeks to straighten out the record and to clarify the record, because I do think it's important. It doesn't perhaps bear on your decisions, but it is important in terms of the integrity of OMB as an institution vis-a-vis the Federal Home Loan Bank Board.

Prior to my time at OMB, my understanding is that Mr. Gray had sought additional staffing resources that were denied. When I checked into that early on—why were the staffing resources being denied—the answer was that the Home Loan Bank Board was not using the staff resources that had been authorized. He simply wasn't using them. So it was a pointless gesture to provide additional staffing resources when he wasn't using the amount of staffing resources—presumably because of internal management problems. He was not able to keep staff on board.

That was my understanding. I don't have firsthand knowledge of that fact. But he was not able to use the staffing resources which had been allocated to the agency.

And I will say again for the record, and I've put this on the record several times.

Soon after I went to OMB, Mr. Gray came to visit me. He said he would be needing additional staff resources. I made the decision virtually instantly, as soon as I was briefed on the Home Loan Bank Board situation, that he needed every bit of additional staffing resources that we could give him. And I told him literally he had carte blanche. Whatever he needed, I, to the extent that I had an ability to sign off, that I would sign off to provide the additional staffing resources.

Now, as a footnote to that—and I wouldn't offer this except he's repeated it so many times that it's a matter of personal integrity as well as institutional integrity—I will say that after I assured him that I would sign off on any additional staffing resources he needed, he went out, I will say, within the week, and announced that he was transferring the remainder of one section of his supervisory staff to the Home Loan Banks. And the reason he gave was that OMB would not give him the staff resources that he needed.

And you can take it from there. Blaming OMB for the Home Loan Bank Board's problems is clearly a red herring. I'm sympathetic with the problems Mr. Gray encountered. But, in defense of OMB, this was not an OMB problem.

I will add one more point and then I will stop. This has been a longer answer than I intended.

One of the ironies with respect to OMB's relationship to the Federal Home Loan Bank Board is that both Mr. Gray and Mr. Seidman lobbied very hard in the Congress, again using OMB as the whipping boy, citing OMB as the problem for the management problems that they were experiencing. They convinced Congress in the recapitalization bill, the first recapitalization bill, to eliminate what's called OMB's "apportionment" authority.

The apportionment authority is used with respect to all Federal agencies. It is a tool that allows OMB to guarantee that agencies don't spend more money than Congress has appropriated. No more, no less. It's that simple.

In the case of the Home Loan Bank Board, since they do not use appropriated monies, it operates somewhat differently, but it's the same effect. The agency in this case, Home Loan Bank Board, tells the OMB examiners how much they expect to be spending in the first quarter or the first month, whichever way it's done, and the apportionment is sent back to the agency authorizing that level of expenditures, so there is legal permission for the agency to spend that much.

If, at any point in time, the Home Loan Bank Board or another agency finds that it needs more money, has unanticipated need at the end of the month or at the end of the quarter, and it's not going to make it to the next apportionment, they simply call OMB, which goes through some very rudimentary procedures and the apportionment is increased.

It is a very, very simple, straightforward process. Home Loan Bank Board had never been denied an increase in its apportionment when it was needed. But they did succeed in convincing the Banking committees and then the entire Congress that OMB should not have this oversight over its activities.

With statutory removal of the apportionment authority, OMB lost one of its very few means of overseeing or controlling Home Loan Bank Board operations.

To this day, to the best of my knowledge, OMB has no means of getting information from the Home Loan Bank Board other than at budget season when we have to have their bottom line numbers for inclusion in the budget. There is no systematic way of getting information from the Home Loan Bank Board other than at the will of the Home Loan Bank Board, as they see fit, when they see fit, to the extent of information that they desire to provide OMB.

I'm sorry to take so long.

The CHAIRMAN. Well, you had important things to say and it was most illuminating. And, you're right, I got more than I bargained for.

Let me come back to the HUD situation. When the news of the scandals broke and you learned about it presumably at that time, did it come come as a shock to you? Were you surprised?

Ms. CRAWFORD. Yes, I was surprised. I was surprised. My knowledge really only goes to what I've read in the newspaper, so keep that in mind. I do not have access to information regarding ongoing cases at the Department of Justice. There are 750, something like that, ongoing cases under investigation.

The CHAIRMAN. In HUD now.

Ms. CRAWFORD. HUD-related investigations in the U.S. Attorney's Offices.

The CHAIRMAN. HUD-related, yes.

Ms. CRAWFORD. I do not have access to that information and I'll make it clear. I have access only to the news accounts that I've read.

Yes, I clearly had no indication of the reported problems.

The CHAIRMAN. Well, let me ask you——

Ms. CRAWFORD. That is not the kind of information that makes its way——

The CHAIRMAN. No, but I would think you were in a key——

Ms. CRAWFORD. Whether it should or not, it simply did not during my tenure.

The CHAIRMAN. But, you were in a high enough position and you certainly would have been in the general milieu of players in the administration that if political favoritism and influence peddling was going on at the scale that we now have determined that it did go on—Secretary Kemp has confirmed that, and so forth—wouldn't you have had some sense of that?

I mean, wouldn't—can that be that pervasive in one major area and just be something that totally misses everybody's attention?

Ms. CRAWFORD. As best I can tell——

The CHAIRMAN. Were there not hints or suggestions or odd behaviors on people's part? I mean, just——

Ms. CRAWFORD. No, again, as I understand the problems that were occurring, there were questionable phone calls made to those who were making decisions about grant awards that were under statutory and regulatory provisions otherwise not controlled by—

let me rephase that. Grant decisions were reportedly being influenced that were not otherwise controlled by the terms of the existing regulations or the statutory framework.

POLITICAL FAVORITISM

The CHAIRMAN. Yes, that's another way to put it. You know, that James Watt example is kind of a celebrated one because he was in the Cabinet and went out into the private sector as nearly as we can put the facts together, and was able to use his influence and former status as a Cabinet Officer to come in and help bend the process to favor a client that he was involved with, and for a very substantial fee.

And, you know, as you go through the procedures, that clearly seems to be an inappropriate way for the decisions to be made. But that wasn't an isolated example. There are a lot of examples like that.

But you're saying that, you know, where you were operating, no sense of this kind of thing going on, the fact that political favors were being asked for and given to the tunes of major grants and ultimately totaling hundreds of millions of dollars.

Ms. CRAWFORD. No. But I think I can perhaps respond in a different way. We had a concern from an analytical, programmatic perspective, as well as the budgetary perspective. My staff and I had a concern more generically about tightening up on programs where they appeared not to be adequately tight, where there appeared to be too much flexibility, too much discretion.

The CHAIRMAN. In other words, a potential for abuse?

Ms. CRAWFORD. A potential for abuse. That's probably better phraseology. As an example, CDBG. I'm talking out of school here, but it's the best way I have to answer the question. There is what is now well-known the discretionary fund in the CDBG program. There are two pieces of that, as I recall, that were legitimate, program-oriented, fairly specifically directed programs, and there were two that, what I recall and, again, I have not gone back and reviewed the program descriptions—and we handled so many, I'm a little nervous about getting locked in——

The CHAIRMAN. Right. Understand.

Ms. CRAWFORD. But my recollection was that there were two in the discretionary program that were entirely discretionary, that simply did not have adequate statutory directives about what those funds were to be used for. And I routinely sought to zero out those two pieces, because from a programmatic perspective, not from knowledge that there were impermissible phone calls or that anyone was making an improper decision, but simply there was a potential for abuse that we focused on from a programmatic perspective and that I sought to eliminate. I will say we were never successful in eliminating funding for those two programs. But that's a more generic, more policy-oriented issue.

Generically, and I don't know how you intend to extent your review—and this is not the time or place I think for a review of HUD programs generically—but from what you indicated, Mr. Chairman, Senator Graham will be looking at some of these issues.

I directed my staff and I think it was the President's intent as well, that we focus our program analysis on targeting individual programs toward the most low income, the neediest low-income areas. There are pressures elsewhere and in Congress, of course, that they need not be so tightly directed towards low-income, that there be some flexibility to allow middle and upper income programs.

We tried. I spend many months, as I recall, trying to target CDBG to eliminate some of the upper income areas. The program had begun as a program targeted on low income communities. And over the years, it had been broadened through various mechanisms, statutory as well as regulatory, as I recall, so that now Beverly Hills is receiving an allocation, a formula allocation under CDBG, which, again, I think was not the original intent of Congress. It dilutes the effectiveness of those monies going to the neediest of the communities.

So we were continually focused on trying to target available dollars on the neediest. And also trying to find ways to make the available dollars as cost-effective as possible. For example, using vouchers rather than using bricks and mortar programs that were dependent upon developers as a middle man, if you will, because our analysis showed that you lost—I don't remember, 50 percent, 30 percent—a large chunk of your dollars went out into the transactional cost of producing the unit.

They are much larger policy issues that you will be considering. But that's the kind of analysis that my staff, the budget staff, was involved in, trying to focus on where there is discretionary authority that may not work to the benefit of the intended recipients. Finding the most cost-effective ways of producing the services or the goods.

The CHAIRMAN. Thank you. My time is up.

Senator GRAHAM. Thank you, Mr. Chairman.

I'd like to ask this question of both Mr. Davis and Ms. Crawford. In Mr. Diefenderfer's statement, he made the observation there has been a massive failure of collective oversight responsibilities which includes OMB.

Mr. Davis, from your tenure at the White House, would you agree with that statement?

FAILURE OF OVERSIGHT

Mr. DAVIS. I think in hindsight. I don't think from my tenure in the White House, I don't think I would have ever guessed that while I was there. But, in hindsight and, knowing what we know today, I wouldn't disagree with that statement at all, no.

Senator GRAHAM. While you were there, you never had any sense that the management of the programs that were under your portfolio were less than at an acceptable level?

Mr. DAVIS. That's correct. I would not have even guessed what we know today, I would not have guessed that was going on at that time.

Senator GRAHAM. Ms. Crawford, would you concur in Mr. Diefenderfer's statement?

Ms. **Crawford**. I'm not sure I can respond for OMB because, again, it is important to remember, the bifurcation that Bill pointed to. And that's the budget side and there's the management side. And I think it's probably a very good idea to try to integrate them more than they were integrated.

During my tenure at OMB, the staff, the budget and the management staff consulted on specific issues. For example, revising financial management systems. Management staff would consult with the HUD budget staff to see if there were particular problems, or how to implement the system, or making sure it didn't impact adversely on HUD programs and things of that sort.

But we did not have oversight I think as you would define it. The budget side did not have oversight in the way you would define it.

But I can't speak for OMB again because I don't know the extent to which the management side has systems in effect that undertook to provide the oversight.

Senator **Graham**. Who had your agency area of responsibility on the management side during the time that you were at OMB?

Ms. **Crawford**. The management side wasn't organized by agency. It was organized by function. There was a personnel function. There's a financial management function. I can't even tell you what the other divisions are.

Senator **Graham**. Was there somebody that you related to who had the title M in their——

Ms. **Crawford**. The Associate Director for Management.

Senator **Graham**. And who was that?

Ms. **Crawford**. It was—there were three people there when I was there. Most recently, it was Jerry Riso. Before that, Carol Dineen.

Senator **Graham**. Were you aware of the statistics that Mr. Diefenderfer stated, which were that during the Nixon administration, there were 224 personnel on the management staff of OMB, and at the end of the Reagan administration, there were 47?

Ms. **Crawford**. No, until I read it in his statement. But I think that is quite an eye-opener and I think it's useful to focus on that.

Senator **Graham**. Was it your sense that there was adequate capacity on the management side, that you felt a sense of comfort that those things that were outside of your responsibility were being properly attended to?

Ms. **Crawford**. I really don't have a feel for that, Senator. We were pinched pretty hard in terms of OMB's budget. All of us were stretched very thin because of our budgetary constraints. Congress has a way of taking their frustrations out on OMB's budget. As a result of that, all of us were stretched very thin.

My guess is that, over those years, as OMB's responsibilities were expanded—for example, with the Gramm-Rudman-Hollings Act—our budgets were cut. The budgetary functions are nondiscretionary in effect. They have to be performed.

My staff worked 24 hours a day, 7 days a week. And I think most budget staff did.

The management systems, I wouldn't say, are less mandatory. They're certainly not discretionary, as I think we have come in hindsight to appreciate. But it may have been that there was a greater ability to whittle away on the management side than there was on the budget side.

On the budget side, you can only reduce it to a certain level and then OMB is just nonfunctional.

Senator GRAHAM. In your area of responsibility, reviewing the budget, going back into the early eighties and persisting up until the current time, there were reports of very substantial losses in various housing finance programs. In FHA and in coinsurance for two. That information was not known to your side of the house?

Ms. CRAWFORD. Yes, in fact, it was. My staff focused on it several years ago. As I recall, we tried to get HUD to focus on it. As I recall, we raised it with several members of the congressional staff. I'd have to go back and ask staff who they checked with, who they raised this with. It became a very serious concern. I'd have to go back and check with my staff to refresh myself who specifically we raised it with.

We did raise it in-house. We raised it with HUD. There were very serious concerns growing. It was viewed to be a very sensitive issue. The feedback we always got when we spoke on the Hill was that it was very sensitive and we shouldn't really—we shouldn't talk about it very much.

Senator GRAHAM. Who were some of the people?

Ms. CRAWFORD. That's what I'm saying, I don't remember. I really——

Senator GRAHAM. That's a very serious—one of the things that concerns me about this is that there are some of us who are elected in this democracy with a responsibility to the public. The President of the United States, Members of the Congress. We all have a responsibility that we cannot shirk by saying some anonymous person failed to do their job

ELIMINATION OF WASTE, FRAUD, AND ABUSE

It is our job. And I'm trying to get a sense of what happened that allowed this to occur. And I think that there was a particular responsibility, frankly, on the Reagan administration because it had made such a high visibility issue out of the elimination of waste, fraud, and abuse. Those became almost a litany of how Government was going to be run.

And when you sense that a person is putting that degree of emphasis on a particular aspect of management—the elimination of waste, fraud, and abuse—there may be a sense that I can relax because I know that this stalwart is placing enormous priority on that issue.

And then when we find that apparently that wasn't the case, it makes us all look that much worse. So I'm trying to determine where we start the rebuilding process.

Ms. CRAWFORD. May I respond to that Senator?

Senator GRAHAM. Yes.

Ms. CRAWFORD. I think that the waste, fraud, and abuse is a catch-word that includes at least two levels of concern and review. In the case of OMB, and again I can only speak for the OMB side and only for the budget side, our focus on waste, fraud, and abuse, if you will went to program analysis. It went to identifying which programs in HUD or the other agencies, which programs were cost-effective, which programs were not cost-effective. Where are we getting the most for our money? Where are we finding that the money is being diluted, is not going to the areas for which the aid is intended? Where is money being siphoned off by developers and is not, in fact, getting to the intended beneficiaries. And there's a whole host of programmatic issues that arise. And they are within the purview of OMB and policy staff to try to identify where those problems are, where the Federal taxpayer's dollar is not being used to maximum effect, and not with the intended purpose.

And I would say that I think we did a fairly good job. And I, think we did a very good job. The program analysts who worked on these programs fulltime on my staff the housing staff—did a good job of identifying where there are programmatic problems.

And most of the remedies that we saw were recommended to the Congress in various forms. Some of them were in the form of changes in the housing bill. Others came up as budget proposals.

For example, you mentioned the FHA program. From my very first budget year, as I recall, what I would consider an "abuse" in that catch phrase—one of the abuses of FHA is that the insurance is available for vacation homes. It's available for speculators. It's available for developers as a bridge financing mechanism. It's available for investors.

In our budgetr, the first budget proposal I handled, following legislation, we sought to eliminate those uses of FHA, to bring FHA back to its original purpose, which would be to help the low and middle income first home purchaser. Those proposals were rejected out of hand by the Congress, again because of a variety of other pressures that were at work. I would categorize that as a programmatic abuse. I won't follow up on it and I won't make a long-winded answer.

The second part of the waste, fraud, and abuse is the individual grant, the individual—the implementation and administration of programs. My sense is and my experience is that that's within the purview of the IG.

Now, to the extent that the IG's identify problems and recommend remedial action, I think it makes perfectly good sense. And Bill made the point that OMB is going to follow up on those IG reports.

But I would break it into those two levels.

Senator **Graham**. Well, using that analysis, the first category that you describe as abuse, which is where you think the program is essentially misdirected, does not produce the optimum benefit to the public for funds expended, that becomes a matter of judgment.

And that, frankly, is what a political democracy does, is bring the judgment of a number of people to bear on a single issue. And at some point, a resolution is reached.

But, as an executive, you have the responsibility to effectively manage all the programs, those that you agree with and those that you don't agree with.

Ms. **Crawford**. Correct.

Senator **Graham**. Do you believe that the fact that the section 8, Moderate Rehabilitation Program, was one that throughout the administration was advocated to be terminated, that that lack of support for the program itself at a policy level affected the manner in which OMB or the White House subsequently monitored the program?

Ms. **Crawford**. I don't know how to answer that. It's possible that it did, in fact, because it was a programmatic decision within OMB, endorsed by the President, that it was not a cost-effective program and that it should be terminated. And I am speaking off the top of my head now because I couldn't go back without running this by my deputy, my former deputy and branch chief and examiners, whether they, in fact, did spend less time because they knew that this was a program that we thought was ineffective and not cost-effective, that they weren't focusing as much attention on it; that they were rather focused on other programs in trying to fine-tune and identify where other programs ought to be——

Senator **Graham**. For instance, within OMB, one program that was very much supported by the administration was the enlargement of the Defense Department. Were resources from OMB shifted from those programs that the administration didn't support, such as low-income housing, to the Defense Department so that the high level of scrutiny, of activities there could be provided?

Ms. **Crawford**. I really can't answer that. I don't know. My understanding, and I'm a little reluctant to answer this because I don't know this for a fact, but my understanding was, in the early years of the Reagan administration, Mr. Stockman allocated greater resources to the Associate Director who handled national security issues, which is where the Defense budget was, because he wanted to exercise greater oversight to identify problems and make sure that the funds were used responsibly.

Senator **Graham**. Do you think that might be another reason why Mr. Diefenderfer concluded that there has been a massive failure of collective oversight responsibilities?

Ms. **Crawford**. No. I think what he's intending is that the buck doesn't stop at OMB. I think that's his——

Senator **Graham**. Well, he said no, which includes OMB. He didn't say that it doesn't——

Ms. **Crawford**. I think that, I mean, I would endorse what he said. Again, I'm a little bit at a large disadvantage because the oversight role of OMB to the extent there was the management oversight, which is I think what you're focusing on, really occurred in a different section of OMB and I don't have that much familiarity with the kinds of systems that were in place.

So what you're really saying is we're talking to a very significant and knowledgeable person, but the wrong person in terms of the questions that we specifically have to ask?

Ms. **Crawford**. Well, I think that's probably right. I'm happy to visit with you. I've enjoyed it. But I'm not sure I can answer the questions that you're looking for.

Senator **Graham**. We will not pursue any further questions relative to whether what you've just said meets the testimony that you have given is the truth, the whole truth and nothing but the truth so help you God, relative to your enjoyment of this. [Laughter.]

Ms. Crawford, I've been given what is stated to be an organizational chart of OMB during the period that you were there. And it indicates that your immediate superior was a Mr. Tim Morris?

Ms. **Crawford**. Tim Muris.

Senator **Graham**. Muris. Is that correct?

Ms. **Crawford**. It really isn't. The chart probably shows it that way. I think his title was Executive Associate Director. My immediate superior was the Deputy Director.

Senator **Graham**. Mr. Wright?

Ms. **Crawford**. Yes.

Senator **Graham**. Joe Wright.

Ms. **Crawford**. Joe Wright.

Senator **Graham**. Now, the management unit, to whom did it report?

Ms. **Crawford**. The Deputy as well.

Senator **Graham**. So, Mr. Wright was directly responsible for both the budget side and the management side of the office. Is that correct?

Ms. **Crawford**. Yes. To the same extent that the Director would be.

Senator **Graham**. During the period that you were in this position, did anyone request you to use any influence over the Department of HUD on behalf of a specific project pending before the Department?

Ms. **Crawford**. No. To the extent that I ever, and I was trying to think this through as you were asking the question of Mr. Davis, to the extent I recall only one case where there was a call on a grant. And it was a congressional call; it was not an outside call. Concern where two different Congressmen, each of them wanted the grant in their own districts. And I wouldn't have had any say anyway. I just remember that coming up at one point. I would not be involved in it.

Senator **Graham**. And to your knowledge, were any of the persons who were responsible to you within your unit of OMB ever requested to make a specific inquiry on behalf of a particular project?

Ms. **Crawford**. No.

Senator **Graham**. I want to thank you very much, Ms. Crawford——

Ms. **Crawford**. Thank you.

Senator **Graham** [continuing]. Mr. Davis, I appreciate your very helpful testimony to the committee. Thank you.

Mr. **Davis**. Thank you, Senator.

[Whereupon, at 5 p.m., the committee was adjourned.]

[Additional material supplied for the record follows:]

HUD

Office of Director Department of Housing & Urban Development

August 10, 1989

The Honorable Bob Graham
241 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Graham:

This letter is in followup to a hearing you chaired and in which Judy Truett of my staff made a presentation, on August 2 on the HUD Moderate Rehabilitation program. We ask that this letter be made a part of the hearing record.

We write to clarify and elaborate on your question concerning the apparent lower rents produced by a private nonprofit developer in San Francisco without benefit of the Section 8 Moderate Rehabilitation program and the higher rents achieved in Jacksonville by a developer using the program.

The property described in San Francisco, Pacific Oaks, is new construction containing 104 housing units, fifty-one of which have reduced rents. The market-rate units rent for $575 and the below-market units rent for $390. The building is a garden apartment for senior citizens consisting of one and two-bedroom units.

The example in Jacksonville was a rehabilitation of a 400-unit apartments, all of which have affordable rents through the Section 8 subsidy. The two bedrooms rent for $463 and the three bedrooms rent for $578.

There are several significant differences of which the Committee should be aware to evaluate the total public assistance flowing to each of these projects.

The first is that the Section 8 Mod Rehab program assists "very low income" families exclusively. That means families with incomes below 50% of the area median income. It is not clear from the testimony on the San Francisco property what income group is served. What is clear is that only one-half of the units are made available at below market rents.

Second, tenants in the Section 8 program, by law, pay no more than 30% of their income for rent, to ensure the affordability of the housing. So, the actual rent paid by a Section 8 tenant of very low income may be around $100 or less. The difference between the tenant's rent and the contract rent is paid through the Section 8 subsidy.

Mr. Terner's testimony does not indicate the income level of tenants in the below-market units as well as the percentage of their income paid for rent.

The San Francisco project, according to testimony, benefitted from significant land write-down costs of $20,000 per unit, so that the cost to the nonprofit developer of land was $5,000 per unit. This was achieved because the site was acquired at book value through a foreclosure sale by a California thrift institution. The private developer of the Jacksonville property did not get a land write-down, as the units were acquired at market value from the owner. Therefore, the Jacksonville developer had to carry the cost of debt for acquisition of the units and the underlying land.

The San Francisco developer also benefitted from density increases, permitting him to build more units than would normally be permitted under existing zoning. Those density bonuses, effectively, were another public subsidy and the bonus units had no land cost attached to them. In addition, the San Francisco developer testified that they also benefitted from tax-exempt financing to acquire the site and Low Income Housing Tax Credit to construct the 104 units. The total value of these two public subsidies are not stated in the hearing record. Jacksonville hasn't begun to discuss density bonuses. No tax credit benefits were secured in Jacksonville.

We point this out because the San Francisco developer stated his project received no direct federal subsidy. That is true, but the indirect federal subsidy of U. S. Treasury financing through tax exempt financing and tax credits is just as important to the success of achieving affordable rents which were ultimately produced.

The Jacksonville developer, working through the local public housing authority, used a direct federal subsidy, the guarantee of 15 years of Section 8 rental assistance to finance the cost of rehabilitating the apartment building. And the program assisted rents for families, which is its purpose, as contrasted with the senior citizen housing produced in San Francisco.

Family housing involves larger units with more bedrooms (two's, three's and four's) and hence, greater per unit costs, than does senior citizen housing of efficiencies and one-bedroom units.

Because the Section 8 Mod Rehab project involved federal funds, the developer ultimately selected through competition to rehab family housing had to comply with Davis-Bacon wage rates; Sec. 8 (a) minority contracting requirements, Sec. 504 Rehabilitation Standards, HUD minimum design standards, fair housing and equal employment opportunity laws, and a host of other federal contracting and procurement requirements. The San Francisco developer, in contrast, was not bound by these requirements.

So, there are significant differences between the two projects, cities, type of units, costs of land, labor, and codes, and type of federal assistance which distinguish them. Both served the purpose of creating affordable housing.

Finally, the Section 8 Moderate Rehabilitation Program was mischaracterized as one where private developers become "administrators of government subsidy programs". That is not the case, Senator. The administration of the program is the responsibility of the local public housing authority which contracts with the developer to produce affordable housing at pre-determined rents for a fixed period of time. The housing authority administers the program, assuring that the building meets code standards, that tenants meet income eligibility tests, that the rehab costs and resulting rents fall within HUD requirements.

The developer under the MOD Rehab program, as the HUD Inspector General testified, derived most of his excess profits, not from the HUD program, but from the syndication of tax credits.

This is not to say the MOD Rehab Program nationally is without flaws. Clearly, close attention must be paid to rehab costs and proposed rents to assure they meet HUD-established Fair Market Rent levels and are not inflated. We have monitored very closely in Jacksonville and this is not an issue here.

Secretary Kemp has moved swiftly and forcefully to take the Central Office "discretion" out of the awarding of Section 8 funds by advertising the remaining 2900 MOD Rehab units on a national competitive basis. We believe this is a long-overdue step in the right direction of rewarding need and demonstrated track record. It is a step we recommended to HUD over three years ago. However, in saying this, I am disheartened that Jacksonville is no longer designated as eligible to receive funding.

Thank you for the opportunity to elaborate on this matter for the hearing record.

Sincerely,

Rich L. Bowers

Richard L. Bowers
Director

RLB:jh

Purchase - $3.3 million $16,500/unit
Rehab - $3.6 million $18,000/unit

U.S. HUD's form to figure Rent Calculation for Moderate Rehabilitation

SAMPLE Mod Rehab
Rent Calculations based
on Jacksonville, FL
Fair Market Rent

7420.3 REV-2 CHG 11

EXHIBIT 2 (Page 1 of 5)

Owner Proposal Number:__________
Agr./HAP Contract Number:__________

CALCULATION OF BASE RENTS AND CONTRACT RENTS FOR MULTIFAMILY UNITS

Owner Name:__________ **Property Address:**__________

Total Number of Units in Property: 200 **Number of Assisted Units:** 200

(___0 BR, ___1 BR, 100 2 BR, 100 3 BR, ___4 BR, ___5 BR, ___6 BR)

Purpose of Calculation: ☒ Proposal Feasibility ☐ Agreement Rents
☐ HAP Contract Rents ☐ Other:__________

Reviewer:__________
(Name of staff person) (date)

Approval:__________
(Name of supervisor) (date)

I. MONTHLY BASE RENT - RENT APPROACH

1. Current Rent (If applicable, also complete Section VI.)

0 BR	1 BR	2 BR	3 BR	4 BR	5 BR	6 BR
$	$	$	$	$	$	$

II. MONTHLY BASE RENT - COST APPROACH

(Use figures for all units in property, assisted and unassisted.)

2. Property Debt Service $342,840 /yr.
$3,000,000 @ 11% for 30 yrs. = 28,570 $3.3 million price
3. Utilities Paid by Owner (included in rent) $ -0- /yr.
4. Insurance $28,000 /yr.
5. Taxes $90,000 /yr.
6. Management and Routine Maintenance 1000 x 200 units $200,000 /yr.
7. Reserve for Replacement $31,500 /yr.
(Based on attached calculation or 10% of sum of Lines 4 through 6 $315,000)

Submitted by: Judith A Truett, Chief
Prepared by : Douglas S. Faust, Housing Development and Rehab Manager
Jacksonville Housing and Urban Development

EXHIBIT 2 (Page 2 of 5)

8. Return on Investment (Up to 10% of (a) purchase price $3,300,000 + capital expenditures $ -0- - outstanding indebtedness $3,000,000 = $ 300,000 or (b) appraised as-is value $______ - outstanding indebtedness $______ = $______) $30,000 /yr.

9. Total Property Annual Base Rent (Add Lines 2 through 8) $719,340 /yr.

10. Occupancy Factor between .95 and 1.00 .95

11. Total Property Annual Base Rent Adjusted for Vacancy and Collection Losses (Line 9 ÷ Line 10) $757,200 /yr.

12. Total Property Monthly Base Rent (Line 11 ÷ 12 months) $63,100 /mo.

13. Base Rent for Assisted Units in Properties with Only One Unit Size (Line 12 ÷ Total Number of Units)

0 BR	1 BR	2 BR	3 BR	4 BR	5 BR	6 BR
$	$	$281	$350	$	$	$

(If more than one unit size, complete Section VI.)

III. MONTHLY BASE RENT - AGREEMENT/HAP CONTRACT

14. Base Rent from (check only one block):

☐ Line 1,
☐ Line 13, or
☒ Line 23, Section VI

0 BR	1 BR	2 BR	3 BR	4 BR	5 BR	6 BR
$	$	$ 281	$350	$	$	$

BASE RENTS ON LINE 14 CANNOT EXCEED THE EXISTING HOUSING FMRs LESS APPLICABLE UTILITY ALLOWANCES:

	0 BR	1 BR	2 BR	3 BR	4 BR	5 BR	6 BR
a. Existing FMRs	$	$	$ 446	$578	$	$	$
b. Utility Allowances	$	$	$ 75	$ 85	$	$	$
c. Maximum Base Rents (Line a - Line b)	$	$	$ 371	$493	$	$	$

EXHIBIT 2 (Page 3 of 5)

IV. MONTHLY REHAB DEBT SERVICE

15. Total Eligible Rehab Costs (Total eligible construction costs $ 3,600,000 + other eligible rehab costs $ -0- - rehab grants $ -0-) — $3,600,000

16. Rehab Loan Debt Service ($3,600,000 rehab loan @ 11% for 15 years) — $40,917 /mo.

17. Imputed Debt Service for Owner Cash Expenditures ($ -0- rehab cost @ 10% for 15 years) — $ -0- /mo.

18. Total Rehab Debt Service (Line 16 and Line 17) — $40,917 /mo.

19. Average Rehab Debt Service per Unit (Line 18 ÷ total number of units to be assisted) — $205 /mo.

V. MONTHLY CONTRACT RENT - AGREEMENT/HAP CONTRACT

20. Contract Rent (check only one block):

☐ Base Rent plus Monthly Rehab Debt Service (Line 14 and 19), or

☒ by Allocation Formula, Line 26, Section VII (e.g., if more than one unit size)

0 BR	1 BR	2 BR	3 BR	4 BR	5 BR	6 BR
$	$	$463	$578	$	$	$

CONTRACT RENTS ON LINE 20 CANNOT EXCEED THE MOD REHAB FMRs LESS APPLICABLE UTILITY ALLOWANCES:

	0 BR	1 BR	2 BR	3 BR	4 BR	5 BR	6 BR
a. Mod Rehab FMRs	$	$	$535	$668	$	$	$
b. Utility Allowances	$	$	$ 75	$85	$	$	$
c. Maximum Contract Rents (Line a - Line b)	$	$	$460	$583	$	$	

EXHIBIT 2 (Page 4 of 5)

VI. BASE RENTS BY ALLOCATION FORMULA

21.

	(a) Base Rents (Line 1, Current Rent)		(b) No. of Units in Property		(c) Total Base Rents	(d) Maximum Base Rents (Sec. III)		(e) No. of Units in Property		(f) Total Maximum Base Rents
0 BR	$	x		=	$	$	x		=	$
1 BR	$	x		=	$	$	x		=	$
2 BR	$	x		=	$	$446	x	100	=	$44,600
3 BR	$	x		=	$	$557	x	100	=	$55,700
4 BR	$	x		=	$	$	x		=	$
5 BR	$	x		=	$	$	x		=	$
6 BR	$	x		=	$	$	x		=	$

Rent Approach: TOTAL Column (c) $______ TOTAL $100,300

Cost Approach: Line 12 $63,100

22. Allocation Ratio (Total Column 21(c) or Line 12 ÷ Total Column 21(f)) .6291

23. Base Rents by Allocation Formula (Line 22 x Maximum Base Rents in Column 21(d))

0 BR	1 BR	2 BR	3 BR	4 BR	5 BR	6 BR
$	$	$281	$350	$	$	$

VII. CONTRACT RENTS BY ALLOCATION FORMULA

24.

	(g) Base Rents (Line 14)	(h) No of Units to be Assisted	(i) Total Base Rents	(j) Total Rehab Debt Service (Line 18)	(k) Total Contract Rents	(l) Maximum Contract Rents (Section V)	(m) No of Units to be Assisted	(n) Total Maximum Contract Rents
0 BR	$		$			$		$
1 BR	$		$			$		$
2 BR	$281	100	$28,100			$535	100	$53,500
3 BR	$350	100	$35,000			$668	100	$66,800
4 BR	$		$			$		$
5 BR	$		$			$		$
6 BR	$		$			$		$
			TOTAL $63100	+ $40917/mo.	= $104,017			TOTAL $120,300

EXHIBIT 2 (Page 5 of 5)

25. Allocation Ratio (Column 24(k) ÷ Total Column 24(n)) .8646

26. Contract Rents by Allocation Formula (Line 25 x Maximum Contract Rents in Column 24(l))

0 BR	1 BR	2 BR	3 BR	4 BR	5 BR	6 BR
$	$	$463	$578	$	$	$

VIII. REHAB LOAN DEBT SERVICE BY ALLOCATION FORMULA

27.	(o) Loan P & I (Line 16)	(p) Total Maximum Contract Rents (Column (n))	(q) Allocation Ratio		(r) Maximum Contract Rents (Column (l))		(s) Rehab Amount by Unit Size
0 BR				x	$________	=	$________
1 BR				x	$________	=	$________
2 BR				x	$________	=	$________
3 BR				x	$________	=	$________
4 BR				x	$________	=	$________
5 BR				x	$________	=	$________
6 BR				x	$________	=	$________
	$________ ÷	$________ =	________				

KELLEY DRYE & WARREN
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

2300 M STREET, N.W.
WASHINGTON, D.C. 20037

(202) 955-9600
TELECOPIER (202) 955-9792
TELEX 5108007600

BRIAN CHRISTALDI
CHARLES L. EDSON
CLIFFORD J. GROEN
UINOT, JR.
OND J. GUSTINI
ETH G. HANCE, JR.
ARTHUR R. HESSEL
BUD G. HOLMAN
JOHN G. IMMER
GLENDON E. JOHNSON, JR.
BRUCE S. LANE
EDWARD M. LEBOW
LAWRENCE Z. LORBER
CHARLES L. MARINACCIO
JUN MORI
MYRON H. NORDQUIST
JOHN W. SIMPSON
FRANCIS Y. SOGI
HERBERT F. STEVENS
SAMUEL C. ULLMAN, P.A.
DAVID L. VAUGHAN
JUSTINE E. WILCOX

HERBERT M. FRANKLIN
RICHARD S. GOLDSTEIN
JEFFREY S. LESK
PAUL LUBETKIN
EDWARD R. VENIT
NEIL T. PROTO
COUNSEL

101 PARK AVENUE
NEW YORK, NY 10178
(212) 808-7800

515 SOUTH FLOWER STREET
LOS ANGELES, CA 90071
(213) 688-1300

50 CALIFORNIA STREET
SAN FRANCISCO, CA 94111
(415) 989-3530

SIX STAMFORD FORUM
STAMFORD, CT 06901
(203) 324-1400

2400 MIAMI CENTER
100 CHOPIN PLAZA
MIAMI, FL 33131
(305) 372-2400

303 WEST MADISON STREET
CHICAGO, IL 60606
(312) 346-6350

175 SOUTH STREET
MORRISTOWN, N.J. 07960
(201) 267-4948

HIBIYA PARK BUILDING, 9TH FLOOR
1-8-1 YURAKUCHO, CHIYODA-KU
TOKYO 100, JAPAN
(03) 213-3631

May 26, 1989

Mr. James E. Schoenberger
Chairman, Mortgagee Review Board
United States Department of Housing
and Urban Development
451 Seventh Street, S.W., Room 9100
Washington, D.C. 20410

Dear Mr. Schoenberger:

On March 20, 1989, John J. Conners, Assistant Inspector General for Audit, transmitted to you Audit Case Number 89-TS-221-1005, Report on Benton Mortgage Company, (the "Benton Audit" or the "Audit") (Exhibit A). The Benton Audit covered 14 projects (the "Projects") for which Benton Mortgage Company ("Benton") provided coinsured mortgage financing pursuant to Section 221(d)(4) or Section 223(f) of the National Housing Act, as amended. Each of the Projects is subject to a Housing Assistance Payments Contract ("HAP Contract") executed between the Housing Authority and the owner providing rental subsidies through the Section 8 Moderate Rehabilitation ("Mod Rehab") program.

In a letter dated March 23, 1989, you transmitted the Audit to Fred Benton, Chairman of the Board of Benton (Exhibit B), officially informing Benton of the existence of the Audit and its referral to the Mortgagee Review Board ("MRB") for appropriate action. You informed Benton that it had the right to submit a response no later than 30 days subsequent.

On April 17, 1989, we requested an extension of time to file an answer (Exhibit C). On April 24, 1989, in a letter addressed to this office, you extended the response time until May 26, 1989 (Exhibit D).

Benton disagrees with the majority of the Audit findings, and with the procedural steps being taken by the Department to resolve the questions which have been raised by the Audit. The scope of the Audit findings greatly surprised Benton, whose officials continue to affirm that they were operating wholly within the scope of program objectives. Benton asserts that the matters in question reflect a lack of appropriate program direction by HUD, and involve a substantial number of participants in the Projects, including HUD personnel, PHA personnel and developer/contractor personnel, many of whom have been the subject of considerable criticism, and whose records and, in some cases, cooperation, have been unavailable to Benton in connection with its preparation of this response. In addition, it is our position that HUD's auditors have intentionally distorted program objectives in their reports.

Representatives of the Office of Inspector General ("OIG") devoted substantial resources to developing its Audit findings, taking at least eleven months from its first visit to Benton's offices until the Audit was released. (According to recent testimony by Paul Adams, HUD's Inspector General, 15 1/2 man years have been spent on Mod Rehab audits.) The extensive nature of the material analyzed by HUD's auditors has made it difficult, in less than sixty (60) days, for Benton's personnel and advisors to prepare a complete analysis of each of the specific Audit findings. Additional information could be furnished, if required.

In judging this submission, please keep in mind the following:

a. Benton is an experienced lender whose principals have from 7 to 20 years experience in financing affordable housing for low and moderate income families, and whose financial strength exceeds all HUD coinsurance requirements (See Financial Statement, Exhibit E, and Organizational Chart, Exhibit F);

b. Benton in connection with GNMA mortgage-backed securities issued by it to support its loans, has never failed to pay a GNMA security holder in full and on time, and has contributed a current total of approximately $6,400,000 to HUD's General Insurance Fund;

c. The majority of criticisms against Benton directly concern unresolved policy issues or programmatic problems recognized by HUD and well documented in recent audits;

d. Benton actively solicited policy guidance when necessary, and has complied and will continue to comply with the instructions that HUD Headquarters conveys; and

e. Benton has admitted those instances where, in retrospect, it appears that good faith errors were made, and has steadfastly worked to improve its technical processing capabilities in response to useful guidance from HUD's program staff and has consistently modified its procedures in response to HUD program directives.

The OIG's decision to refer the Benton Audit to the MRB for the possible imposition of sanctions is singularly inappropriate in light of the evident problems in the Mod Rehab and coinsurance programs, particularly when coupled with HUD's determination to simultaneously discipline Benton programmatically, all as set forth below.

Description of Benton

Benton is a Tennessee corporation with 47 employees; its main offices are in Knoxville, Tennessee. It was formed in 1985. All of the shareholders and primary officers of Benton work in its lending business day-to-day, and are individuals who have had substantial experience in HUD programs.

The principals of Benton have been actively involved in financing projects built under HUD programs for up to twenty years (Exhibit G). They have been at the forefront of underwriting tax-exempt bond issues to finance Section 8 subsidized housing projects both with and without FHA insurance. They underwrote over 300 tax-exempt multifamily bond issues with 178 of the issues being to finance Section 8 subsidized projects. As the laws governing tax-exempt bonds continued to change and reduce the size of the tax-exempt market, the principals of Benton, desiring to continue their involvement on the delivery of low and moderate income housing, believed that the FHA coinsurance programs provided the most viable source of financing for such multifamily housing. Consequently, Benton Mortgage Company was formed to act as an FHA insured mortgage lender and coinsurer. From the date of its formation, as its portfolio has grown, Benton has continually increased its staffing and adjusted its procedures to expand its capacity and meet changing program guidelines.

Each of Benton's coinsured loans has been funded through the issuance of GNMA mortgage-backed securities. In 1988, Benton issued the second largest amount of GNMA securities of any multifamily lender in the country. Benton has always met its obligations to the holders of these securities.

Benton's coinsured mortgage portfolio is secure, and has never resulted in a claim against the FHA insurance funds. Benton participates as a mortgage lender in the HUD full insurance program and the Section 221(d) and 223(f) coinsurance programs and is among the first lenders preliminarily approved to participate in the Section 232 nursing home coinsurance program. Benton has closed 146 coinsured loans with a loan value of $636,389,100. Of these, 105 loans represent projects receiving Section 8 subsidy, including 51 coinsured loans for projects receiving subsidy under the Section 8 Mod Rehab program. Only two of Benton's coinsured loans are currently in default: one has an underpayment of just $5,000, one is two months in arrears. The first loan is currently under a workout agreement providing for a $1,000 per month deficiency for calendar year 1989. Benton holds a $2,500,000 letter of credit on the latter project and expects to negotiate an acceptable workout plan with the owners. Benton's coinsured loan portfolio generates over $2.4 million in annual mortgage insurance premiums payable to HUD. Including the earlier tax-exempt financings, the total value of the mortgage portfolio for which the principals of Benton have performed underwriting activities is over $3 billion. Benton has been an important participant in the various HUD programs, providing funding sources nationwide.

Benton enjoys a strong reputation and proven record as a mortgage lender. As such, the Federal National Mortgage Association has selected Benton as one of 16 lenders approved under FNMA's Delegated Underwriting and Servicing Program.

Description of Mod Rehab Program

The Mod Rehab program was created by Congress as part of the Section 8 Existing Program, under the Housing and Community Development Amendments Act of 1978 (the "1978 Amendments"), now made part of the United States Housing Act of 1937, and is governed by regulations codified at 24 CFR 882.401. The 1978 Amendments were enacted with the stated goals of upgrading substandard rental housing in the United States and providing rental subsidy for lower-income families. Public housing authorities ("PHA") were authorized to use subsidy funds of the Mod Rehab program to provide rental assistance to low-income persons residing in properties needing physical rehabilitation. Subject to HUD rules and procedures involving allocations of

Section 8 subsidy authority, PHAs participating in the program are required to solicit and receive proposals from property owners who are interested in obtaining a guaranteed stream of rental income in the form of rental subsidy for low-income tenants after the property has been rehabilitated. The PHA then proceeds to select properties for participation in the program. While selection criteria may be tailored to meet targeted local housing needs, the PHA is required to give a preference to proposals indicating the greatest amount of necessary rehabilitation per unit. (See 24 C.F.R. 882.504(c)(4))

Once properties are selected by the PHA for participation in the Mod Rehab program and various other requirements met, HUD and the PHA enter into an Annual Contributions Contract ("ACC"), and the PHA and the property owner enter into an Agreement to enter into a 15-year Housing Assistance Payments ("HAP") Contract under which the PHA administers the rent subsidy to the owner. The PHA also takes on the role of overseeing the rehabilitation work, so as to guarantee that HUD Housing Quality Standards or other standards approved by HUD are met. After rehabilitation is complete and the HAP Contract executed, the PHA administers the rental assistance benefits to eligible lower income families residing in the property.

"Moderate rehabilitation" is defined as a minimum of $1,000 of rehabilitation work per housing unit (which amount includes a pro-rated share of work to be accomplished on common areas or major project systems), so long as the rehabilitation expenditures fall within two broad categories: to upgrade the property to meet HUD Housing Quality Standards or other standards approved by HUD, or to repair or replace major building systems that are in danger of failure. Therefore, Mod Rehab assistance cannot be attached to properties requiring only routine maintenance, upkeep or repairs.

While there is no specific maximum limit to the amount of rehabilitation which is permitted under the program, cost control is established through compliance with Fair Market Rent limitations. (See e.g. Program Audit, p. 24) The Fair Market Rents ("FMR") under the Moderate Rehab program are 120% of the FMR schedule for the Section 8 Existing Program (HUD can, on a individual project basis, approve "exception rents" up to the 132% or 144% level). The initial contract rent is calculated to equal the estimated cost of owning, managing and maintaining the unit plus the monthly amortization cost of the rehabilitation financing, so long as this initial contract rent does not exceed the Mod Rehab FMR schedule. The Mod Rehab regulations do not contain any requirements that initial contract rents be set by any market comparability standard.

Finally, it is important to note that the Mod Rehab program is a subsidy program and not a financing program. Although HUD has determined that the FHA insurance and coinsurance programs are available to finance Mod Rehab projects, an owner can also -- and most often does -- use other sources of financing. The Mod Rehab program itself does not require lender participation in the calculation of subsidy or regulation of program participants. The lender is not a party to the HAP Contract, is given no compliance functions, and does not have authority under the program to set rents.

The OIG and Mod Rehab

The Benton Audit is not the only recent OIG audit to deal with the Mod Rehab program. In its semi-annual Report to the Congress, dated November 20, 1988, the OIG announced that it planned to issue, during the first quarter of Fiscal Year 1989, over 25 audit reports covering HUD and PHA activities in connection with the Mod Rehab program, and stated:

> "Thus, our audit has identified a number of serious weaknesses in MRP administration. Specifically, we found that: (1) the majority of MRP projects funded over the last 5 fiscal years were selected without the type of open competition intended in HUD regulations and directives governing the MRP; (2) PHA staffs did not demonstrate the capability to properly prepare specifications, estimate costs, distinguish between eligible and ineligible rehabilitation costs, and compute appropriate rental rates; (3) HUD staff did not effectively monitor or assist PHAs; and (4) the current contract rents that govern the amounts of HUD's housing assistance payments exceed those that are necessary and reasonable." (Exhibit H)

As of this date over 20 such audits have been released by the OIG (Exhibit I), in addition to the Benton Audit. The HUD Inspector General has publicly stated that at least 10 other such audits are currently in progress. None of the other audits involve lenders, nor do any involve owners or contractors (although we understand that several such audits may be under way, including audits involving all or some of the 14 Projects discussed in the Benton Audit). The other audits involve PHA's or HUD itself.

In this regard, on April 26, 1989, the OIG issued to you, as General Deputy Assistant Secretary for Housing -- Federal Housing Commissioner, its Audit No. 89-TS-103-1005, entitled "Audit of Section 8 Moderate Rehabilitation Program" (the "Program Audit") (Exhibit J). This audit was extremely critical of HUD's administration of this program, and of the quality of the instructions disseminated by HUD to program participants. It was particularly critical of the confusing manner in which HUD attempted to combine the Coinsurance and Mod Rehab programs. (For a summary of excerpts from the Program Audit demonstrating the extent of programmatic confusion, see Exhibit K.) The Program Audit, on its first page, stated:

> "We found that numerous factors contributed to HUD's inability to administer the MRP in an efficient, effective and economical manner. The audit results when taken collectively show that programmatic weaknesses are numerous and significant and cover the entire spectrum of MRP development activities. For the most part we found the funding allocation process conducted at Headquarters was undocumented and contrary to pertinent regulations. PHAs failed to carry out the MRP in accord with current requirements and HUD Field Office staff did not adequately assist or monitor the PHAs. Over the past two years about half of all projects funded obtained financing through HUD's coinsurance programs. Confusion over the respective roles in determining contract rents . . . ."

At approximately the same time, on April 17, 1989, the OIG issued Investigation File No. HM1-1054, entitled "Thomas T. Demery, Former Assistant Secretary for Housing, HUD Section 8 Moderate Rehabilitation Program" (the "Investigation"), which spoke to "perceptions of favoritism" in the selection of Mod Rehab projects, caused by factors including:

> "apparent allocation of units to specific projects or developers;
>
> receipt of a substantial number of units by certain developers/owners, including several former HUD employees;
>
> payment of substantial fees....by developers to consultants, including several former HUD employees, for assistance in obtaining the allocation of units; and

> apparent access to inside or advance information by former employees and developers."

Nowhere in the Investigation is it stated or implied that Benton was directly or indirectly involved in these matters. Indeed, it was not.

The OIG and the Coinsurance Programs

The OIG has also been looking into various aspects of the FHA Coinsurance Programs. Its first audit of the Coinsurance program was issued on November 5, 1985 (the "1985 Audit"). The 1985 Audit concentrated on many of the same issues raised in connection with the Section 223(f) program by the Benton Audit, thus showing HUD's failure to address any of them programmatically (See Exhibit L). On December 9, 1988, it issued Audit No. 89-TS-119-0002, Report on Audit of the Section 223(f) Coinsurance Program, focusing on three particular lenders (not including Benton). In its summary, the OIG stated: "Our audit disclosed that lenders were underwriting unsound loans, failing to detect indications of troubled loans in a timely manner, and were not taking adequate and timely action to minimize mortgage defaults and coinsurance losses." One of the three lenders involved (DRG Funding Corp.) has subsequently been dropped from the coinsurance program by HUD. In this connection, it is important to reiterate that Benton's portfolio is actuarily sound and the Company's capital resources exceed applicable requirements.

In addition, it has recently been reported by The Washington Times (Exhibit M) that the OIG is about to release another programmatic coinsurance audit.

Finally, there has been much additional criticism levied against the coinsurance program and the manner in which it has been established and administered. Significant attention has been focused on the quality of coinsurance underwriting, the current and projected default level, and program's ultimate effect on the FHA insurance funds. It is our understanding that a substantial number of other coinsured lenders, in addition to DRG Funding Corp., have recently been suspended or put on probation by the Department, and all pending lender applications for participation in the program have been suspended. (Exhibit N).

The Benton Audit

From what has been stated and cited above, it should be clear that the findings set forth in the Benton Audit cannot be viewed in isolation of the turmoil surrounding both the Mod Rehab and Coinsurance Programs, and particularly with:

A. The allegations of program confusion surrounding the proper operation and HUD's administration of the Mod Rehab program (allegations which Benton believes to be substantially supportable);

B. The allegations of favoritism and impropriety in the allocation of Mod Rehab units (allegations which are in no way directed against Benton and with which Benton has no involvement); and

C. The general allegations of improper underwriting of coinsured loans and the resultant danger to the FHA insurance funds (there are no allegations of danger of claims in connection with any loans in Benton's portfolio).

The degree of programmatic confusion described in the Program Audit created a set of circumstances where decisions were necessarily made on the basis of *ad hoc* requests for guidance from HUD officials at various levels (such requests often generated by owners, even when -- as a matter of form and accommodation -- submitted by lenders), and the reliance upon responses to such inquiries (sometimes in writing and sometimes oral) both in individual cases and as precedents.

In addition, it is our position that Benton has not been fairly treated by HUD in the audit and audit resolution process.

By regulation, the powers of the MRB are directed to the imposition of sanctions -- letters of reprimand, orders of probation, suspensions or withdrawals of approval (See 24 CFR Part 25 generally). By practice, the MRB also enters into agreements of settlement with mortgage institutions under its jurisdiction. The question here, therefore, is whether sanctions are justified and whether, in the particular instance, it would be appropriate for the MRB to negotiate a settlement agreement with Benton. Our answer, to both questions, is an emphatic "no."

To understand our position fully, one must review the history of HUD oversight of Benton's activities over the past year.

1. Following an October 1987 field inspection by Housing, and a substantial amount of review of Benton's procedures, on June 13, 1988, former Deputy Assistant Secretary for Multifamily Housing Programs R. Hunter Cushing issued a comprehensive coinsurance monitoring review ("Monitoring Review") of Benton's coinsurance activities, with separate comments and recommendations for Benton's architectural, cost valuation, and mortgage credit functions. Although terming Benton a "knowledgeable and sophisticated lender," the document cited a number of deficiencies and made a number of criticisms, to which it invited response. The enclosures to Mr. Cushing's letter stated the comments were based on a review of a specified list of projects (Exhibit O).

2. While the Monitoring Review was proceeding, Benton was informed that HUD's OIG was going to conduct an audit of its coinsurance and Mod Rehab activities, focusing on 14 projects, many of which were also being reviewed as a part of the Monitoring Review. It was led to believe that this audit was a normal procedure, and was informed that it should continue to prepare its response to the Monitoring Review. It did so, while opening its files and offices completely to the OIG's representatives.

3. After substantial analysis and a series of communications and meetings with HUD Headquarters coinsurance staff, Benton submitted a written response to the monitoring Review (Exhibit P). Benton did not attempt to be defensive or confrontational in its response. This response was extremely forthright, agreeing with a large part of HUD's criticism, although explaining that part of the problems were start-up in nature, and/or having to do with the serious illnesses of some key personnel. The response explained a number of staff and procedural changes being adopted by Benton to strengthen its coinsurance operation. HUD staff seemed satisfied.

4. In the meantime, the OIG audit progressed. In the late fall of 1988, the OIG requested a conference. As Fred Benton, Chairman of the Board, was seriously ill in a Florida hospital, Benton Mortgage Company requested postponement of the conference. Finally, in mid-January, 1989, OIG representatives met with Benton officials and gave Benton a draft audit report. Reviewing the draft report, Benton officials noted several serious allegations, although much of the ground covered had previously been dealt with through the Monitoring Review and presumably satisfactorily answered. Moreover, Benton representatives were of the

opinion that whereas the Monitoring Review provided useful criticism, the OIG report contained serious distortions of fact, and reached inaccurate and erroneous conclusions. Further, the draft audit report contained no recommendations for resolving the perceived problems, the usual procedure, and simply directed, instead, that the matter be turned over to the MRB for appropriate action. The OIG representatives told Benton officials that Benton would have the right to submit a written response, and would have to do so within a week. When Benton protested this exceedingly short time table, it was told that it had already pushed things off from the late fall, and that -- if a response was not submitted with a week -- the OIG would assume that Benton was making no response. Working day and night, Benton put together as much material as it could, with the understanding from OIG personnel that the response would be considered a "draft," and that -- before the audit was finally released -- Benton would have an opportunity to prepare a "final" response. On January 19, 1989, another conference was scheduled. While the OIG termed this meeting an "Exit Conference," it clearly failed to meet the requirements of HUD Handbook 2000.6, Audits Management System, Chapter 2, Section 2-1(b), and of HUD Handbook 2000.3, REV-3, Office of Inspector General Activities, Section 4-12, as the OIG representatives in attendance were not prepared to discuss Benton's detailed criticism of their report. Thus, Benton never received the benefit of the mandated Exit Conference, and the opportunity to suggest procedural changes to respond to the OIG criticism. (Exhibit Q) Benton's draft written response was submitted to HUD the next day, January 20, 1989. (In contrast, Housing staff took 24 days to respond to the Program Audit, and over 90 days to respond to the draft of the recently released Section 8 Loan Management Set Aside Audit.)

5. On February 14, 1989, the Deputy Assistant Inspector General for Audit ("Deputy IG") informed counsel for Benton that Benton had not been promised an opportunity to respond further at this stage, and would not be able to do so until after the audit was issued. He further stated that Benton's initial response would be published with the final audit. After some discussion as to the propriety of publishing something clearly submitted and labeled as a "draft", it was agreed that Benton would have the opportunity, if again it could be accomplished within a week or so of receiving the final audit report, to submit a letter response, which would be published in lieu of the January 20 submission. This in fact happened, as Thomas Ford's March 9, 1989 letter was published as an exhibit to the Audit.

6. At the same meeting, the Deputy IG reiterated that the OIG was making no recommendations for resolving the audit findings, and was going to submit the matter to the MRB. Counsel suggested that this was not going to promote quick resolution of the matter, and was going to entail significant procedural steps which could be avoided if the matter were referred to the Office of Multifamily Housing ("Housing"). It was our position that the Audit was primarily concerned with complex, technical programmatic matters which could best be resolved by Housing programmatically, and that resolution of these matters involved all coinsurance lenders, not just Benton. Counsel was told that this would not be possible, but that there would be plenty of opportunity for discussion and dialogue over a 30 to 60 day period before any official MRB action could be commenced and that, hopefully, many of these matters could be resolved during that time.

7. As stated earlier, on March 20, 1989, the final audit report was issued by the OIG and delivered to the MRB. On March 23, 1989, you transmitted it to Benton with a 30 day deadline (later extended to 60 days) for response.

8. Knowing how time consuming, expensive and distracting preparation of a full response to the many comments of the OIG on the fourteen projects would be, recognizing that many of these matters had previously been resolved in the Monitoring Review process and taking the Deputy IG at his word, Benton attempted to initiate discussions within the Department. Our goal, of course, was to reach an overall resolution of the matter, but -- at the very least -- we wanted to see what the Department expected of Benton. Did it want Benton to further change any of its procedures? Did it want Benton to show that its current procedures complied with new HUD requirements, or to pledge to comply with future changes in these requirements? Did it want to undertake separate analysis of the 14 projects? Did it want to sanction Benton? Knowing that the Department must view some matters raised by the audit as being potentially more serious than others, we wanted to know how to organize our response, if indeed formal response was necessary.

9. We contacted you to set up a meeting. You said that you believed it would serve us no useful purpose to talk to you, as you were not yet knowledgeable about the details of the audit. You suggested we meet with the MRB staff, which we did.

10. When we met with William Heyman, Director of Office of Lender Activities and Land Sales Registration, and MRB staff representatives, we were informed that they were unaware of the particularities of the Audit findings. We also learned that the MRB had not previously dealt in any significant manner with the Mod Rehab program. We were told that the MRB staff had no authority to discuss substance or settlement with us until asked to do so by the MRB, and that the MRB could only do so upon review of Benton's official response. Mr. Heyman in effect advised us not to make any assumptions with respect to the MRB's position, and that the decision to submit an abbreviated response would be at Benton's risk. Thus, from the MRB point of view, in spite of the OIG advice, neither settlement, nor indeed any discussion of substance, was possible prior to the submission of a full response, and the "docketing" of the matter by the MRB.

11. Mr. Heyman did, however, suggest that it would be appropriate for us to meet with program staff, and that some of the same purposes could be served by such a meeting. Mr. Heyman further said that, in analyzing the matter, the MRB would rely heavily on program staff. With this is mind, a meeting was arranged with James L. Hamernick, Acting Deputy Assistant Secretary for Multifamily Housing and his staff, whom he had directed to review and prepare comments on the Benton Audit. It was hoped that this meeting would be mutually helpful to both Benton and the Department. Preparations for the meeting occurred, and -- at the request of Mr. Hamernick -- Thomas G. Ford, Benton's president, prepared to come to Washington. The day prior to the meeting, however, it was cancelled by HUD, it being apparently determined within HUD that it would be inappropriate before Benton's response to the MRB was submitted.

We thus determined that it would neither be possible to settle the matter in advance of MRB participation, nor to gain a better understanding of HUD's scope of inquiry, and that it would therefore be necessary to prepare a complete response to the findings and allegations contained in the Benton Audit. We hoped that, after the MRB read our response, we would be able to sit down and craft a mechanism to make final determinations as to the specifics of the OIG's findings. We certainly took you at your word in your April 24 letter when you said that

> "Benton should give consideration to responding to each of the specific findings cited in the Audit Report....I assure you that the Board is willing to consider all of the points raised in the audit and all of your responses thereto."

The Program Audit was released on the day of your letter. We were surprised that Benton's participation in the Mod Rehab program was the subject of Finding 5. We question the propriety of a programmatic audit, to which Benton had no opportunity for input or response, discussing in detail Benton's activities. What is more distressing, however, was to see that, as opposed to the Benton Audit pending with the MRB in which the OIG refused to make any recommendation for settlement, the Program Audit contains a firm recommendation of the OIG for at least partial resolution of the Benton matters. Recommendation 5(E), directed to Housing, states:

> "Develop a strategy, and related work plan, for taking the necessary steps to (1) recover excess subsidies paid, (2) reduce the contract rents and related mortgage amounts for the fourteen projects reviewed during our Benton Mortgage Company audit, and (3) review all other coinsured [Mod Rehab] projects and take the same steps as in (1) and (2) when appropriate, . . ."

thus establishing the likelihood that Benton will have to be subject to a review of all of its coinsured, Mod Rehab loans.

What is worse, without having any discussion on the subject with Benton, without taking into account the response to the Monitoring Review, without reviewing the material now being prepared by Benton in response to the Benton Audit, without any participation from the MRB's members or staff, and without waiting for the MRB to consider the matter, Housing -- the group of professionals to whom the MRB is to look for guidance -- has already reached an accommodation with the OIG. To quote the Program Audit:

> "For Recommendation 5(E), you agreed to establish a work plan by May 1, 1989 that will outline efforts to review all coinsured [Mod Rehab] mortgages to determine excess Section 8 subsidies. Those projects not yet at contract execution will be reviewed on a priority basis."

As the OIG refrained from making recommendations towards resolution of the matters raised in the Benton Audit, leaving such determination to the MRB, it should not have made specific recommendations with respect to the same matters in the Program

Audit, and should not have solicited Housing's concurrence in those recommendations, thus (a) reaching conclusions as to the substantive matters which no one in the Department would discuss with Benton, and (b) doing so within the context of an audit that Benton was not party to and to which it was given no opportunity to respond.

Benton was left with the impression that its efforts to put together a response and explain its previous actions were in vain, and that the programmatic staff -- with its own reputation to resurrect -- had agreed with OIG to sell out Benton without giving Benton any chance to respond to the OIG's assertions. Seeing that there was to have been a methodology developed by May 1 to analyze all Benton projects, we therefore requested from the Office of the Federal Housing Commissioner the ability to be informed of and to comment on the proposed methodology, our purpose being to ensure that Benton in that process would get a fair opportunity to explain its previous actions, and that the burden on Benton staff would not be overwhelming. Again, the Department refused to talk with us.

The problem was compounded on May 5, 1989, by your letter (writing as General Deputy Assistant Secretary) to Thomas G. Ford, informing Benton that it was being put on a form of probation with respect to its coinsurance activities for six months. You stated that this was done in light of Benton's coinsurance default rate (a situation never previously discussed with Benton, involving no projects currently threatening the General Insurance Fund and which -- with appropriate explanation -- would not appear threatening to the Department), the Monitoring Review (about which we previously presumed the Department to have been satisfied, and the existence of which caused HUD no hesitation in recently giving Benton preliminary approval as a coinsuring lender under the Section 232 program), and the Benton Audit (which at this point is sitting with the MRB and towards which this response is directed). On May 22, 1989, we attended an informal hearing on the probation action. We are currently awaiting action on Benton's appeal of the probation action.

HUD has to determine in which forum to place Benton. It has currently placed Benton on three separate tracks arising from the Audit, the Program Audit and the probation letter. It is inappropriate and unfair for Benton to be required to justify its actions in parallel forums, as there clearly will be duplication of effort and expense and no assurance of Departmental consistency. We are already concerned that the efforts so far made by Benton in connection with this response might have limited value depending on what Housing and the OIG might have already agreed and decided to do. Similarly, it would be inappropriate for the MRB to reach a negative conclusion as to Benton's activities (as we believe it was unfair for Housing to do so in your May 5 letter) in light of the fact that the programmatic staff has not reached a concensus on the propriety of Benton's underwriting pursuant to the analysis to be made in response to the Program Audit. Further, it would be inappropriate for programmatic staff to develop a methodology to analyze the Mod Rehab program that would not grant due process rights to Benton and other participants in these Projects. Finally, it would be inappropriate for program staff to develop a methodology of analysis that would allow HUD's own shortcomings to be overlooked and projected onto Benton.

Audit Resolution

The documents provided herewith demonstrate that any sanctions against Benton would be improper. We therefore request that the MRB issue a finding to this effect. We further request that the MRB issue a finding that, because of the programmatic confusion, Benton bears no responsibility for the matters discussed in the Program Audit.

In addition, with respect to the resolution of the Audit itself, it is our firm belief and request that the MRB should dismiss this matter and declare the Audit closed. If for some reason, the MRB feels more analysis is needed of any point covered by the Audit, we request the MRB to refer such questions to Housing. It is our further request that Housing be directed to perform this analysis granting full due process rights to Benton. It is also our request that the MRB address this issue with a sense of expediency, and direct Housing to do the same.

The Audit Response

Attached to this letter, you will find Benton's detailed response to the matters raised in the Audit. We believe it shows ample support for the actions taken by Benton in connection with the fourteen Projects discussed in the Audit.

The response to the Audit includes individual narrative responses to Audit Finding 1, Audit Finding 2, Audit Finding 3, and Audit Finding 6, and detailed discussions relating to each of the 14 Projects. Rather than provide narrative responses to Findings 4 and 5, Benton's responses to those findings have been molded into its project-by-project responses.

We would be pleased to submit any additional information you require.

Sincerely yours,

Arthur R. Hessel

ARH:jts
cc: Mr. Fred Benton
    Mr. Thomas G. Ford